Marketing Material

June 2024

Are ESG regulatory and policy measures driving asset allocation?

Passive Investing 2024

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Foreword

Welcome to the latest edition of the CREATE-Research report on passive investing, this time looking at the impact environmental, social and governance (ESG) regulatory and policy measures have on institutional investors' – chiefly pension funds' – asset allocation. Xtrackers by DWS is proud once again to sponsor this important research.

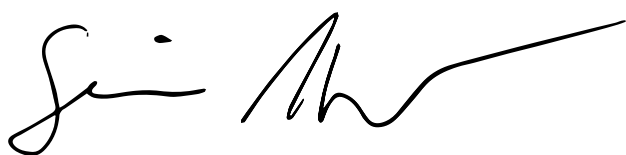
Previous reports in this series have examined pension fund managers' attitudes to sustainability and ESG investment themes. However, this new report comes at an important point of maturation for asset owners in terms of ESG adoption and application, supported by a significant step-up in policy and regulatory initiatives.

Even though the first socially responsible equity indices launched over 30 years ago (KLD Research & Analytics launched the first socially responsible investment index in 1990[1]), it took until the second half of the last decade for investing with ESG factors to really start to take off, following the 2015 Paris Agreement on climate change. There then followed a period of rapid development of investment products carrying ESG labels and moves by regulators and others to create rules and standards for the industry. These rules and standards are now being evolved to the next stage.

As the report highlights, markets have previously struggled to find 'green direction'. What was needed were more concise ESG standards and mandatory data disclosure, more effective stewardship, clarity in the fiduciary duty of pension investors, common taxonomies, and national sustainable finance strategies. Since 2020, there has been a rapid increase in the tempo of development across all these areas. In the US, for example, as well as seeing the introduction of the Inflation Reduction Act, aimed at cutting emissions, we have also seen the Securities & Exchange Commission mandate the disclosure of climate-related information by publicly listed companies and labelling of ESG products, while Europe has enacted its own Green Deal Industrial Plan.

ESG is, therefore, growing up, but has it come of age? How are regulators and policymakers furthering this growing up, does this impact investors asset allocation? These are the central questions the new CREATE-Research report asks. There is no doubt about the continued expansion of ESG investing. Consultants PWC estimate that ESG-oriented assets under management in the European Union will increase from EUR 6.2 trillion to EUR 9.4 trillion within the next three years[2]. ESG is here to stay.

We hope you enjoy this report. There will be more to discuss in future.



Simon Klein
Global Head of Xtrackers Sales, DWS

[1] https://www.msci.com/esg/30-years-of-esg [2] https://www.pwc.lu/en/sustainable-finance/docs/pwc-eu-esg-ucits-poster-2024.pdf

Acknowledgements

"In the middle of difficulty lies opportunity."

Albert Einstein

After a period of rapid growth since the 2015 Paris Agreement on climate change, ESG investing hit a rough patch in 2022-23. Thus far, the media spotlight has focused on underperformance in the bear market and the recent political backlash in the US.

In comparison, the raft of regulatory and policy measures – unprecedented in scale and scope – introduced since the 2020 Covid-19 pandemic have attracted much less media attention. The measures have the potential to transform ESG investing and adoption, as investor ambition is finally being matched by policy action.

This is the subject of the 2024 annual pension survey in a research programme first started in 2018 by Xtrackers at DWS Group and CREATE-Research. It aims to highlight the foundational trends in both sustainable and passive investing.

This year's survey provides a timely perspective on the new measures in the key economies around the globe and how they are likely to affect the asset allocation approaches of long-term institutional investors, specifically pension plans.

My foremost thanks go to the 156 pension plans in thirteen key fund jurisdictions who participated in our survey. Their practical insights for institutional investors shed light on the future of ESG and passive investing and some of the challenges it faces.

I am also very grateful to Xtrackers for sponsoring the publication of this report without influencing its findings in any way. Their arms-length involvement has helped to canvass a wide spectrum of views in the pension landscape so as to deliver an impartial assessment of how the new measures are likely to impact ESG investments by pension plans.

My grateful thanks also go to IPE for helping to conduct the survey and especially to its editor, Liam Kennedy, for his wise counsel and unstinting encouragement throughout the history of this series.

Last but not least, I would like to thank four colleagues at CREATE-Research: Anna Godden for desk research, Lisa Terrett for project management, Naz Rajan for data analysis and Dr. Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors and omissions, I am solely responsible.

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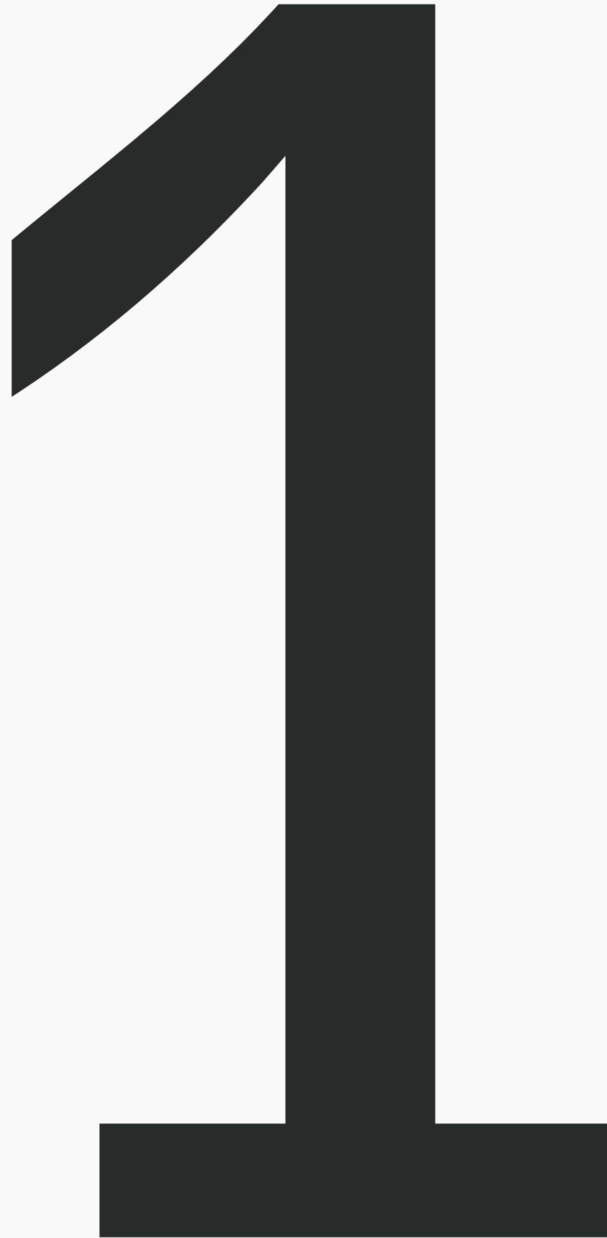


Executive summary

"ESG investing is not an easy one-way ticket for good returns. It requires a lot of due diligence within a robust regulatory framework."

An interviewee quote

Introduction

Are capital markets finally poised to price in environmental, social and governance (ESG) risks and opportunities in earnest after an avalanche of new regulatory and policy measures since 2020?

Before then, price action was selective, sporadic and slow, relying on momentum in the rising bull market.

The causes were twofold: inertia on the part of regulators and their governments; and a dearth of decision-useful data, reinforcing the old refrain 'You can't manage what you don't measure'.

Thus, markets could not find green direction by themselves; nor did a decarbonised portfolio equate to a decarbonised planet.

For that to happen, five fundamental building blocks had to be in place: regulated ESG standards and mandatory data disclosure; effective stewardship; clarity in the fiduciary duty of pension investors; common taxonomies; and national strategies to promote investments in ESG factors. These are necessary for fostering conditions that favour more efficient capital formation, better investor returns, a more sustainable planet and progress towards greater social justice.

In that context, the 2020 covid pandemic was a watershed. It accelerated the regulatory and policy tempo, putting it into overdrive in key economies, according to the latest data from the UN Principles of Responsible Investments.

That year alone saw a 74% increase on 2019 in rules on ESG data disclosure, and an increase of over 100% in ESG integration as reported by UN PRI.

Country examples

The details of these regulatory and policy measures are given in Section 2. Some notable examples include:

- **The USA:** new rules from the Securities and Exchange Commission mandate the disclosure of climate-related information by listed companies and the labelling of ESG products to enhance their integrity. The policy front saw the implementation of the landmark Inflation Reduction Act 2022, which vastly expands the supply of investible projects in clean, renewable energy via generous tax incentives.

- **European Union:** the Corporate Sustainability Reporting Directive (CSRD) mandates corporates to report on ESG risks and transition mitigation, duly linking corporate leaders' variable bonus to such plans. The policy front witnessed the launch of the Green Deal Industrial Plan to boost Europe's net zero industry via net zero industry by promoting new technologies and jobs in the environmental sphere.

- **China:** on the data front, the key stock exchanges now require mandatory disclosure of policies and practices in the area of corporate social responsibility and regular dialogue between companies and their investors. On the policy front, banking and insurance entities are now mandated to adopt strategies to reduce the carbon intensity of their emission-financed asset portfolios in an orderly manner in pursuit of the country's Net Zero goal.

– **India:** the Securities and Exchange Board of India requires listed companies to disclose ESG performance and risks to investors, so as to enhance transparency and accountability. The policy front saw the launch of the ambitious Production-Linked Incentive Scheme to spur new technologies to combat global warming.

Overall, the central thrust of most of these measures is driven by incentives more than sanctions for ESG in general and its environmental pillar in particular. Policymakers and regulators envisage a crucial role for private finance in minimising adverse social and environmental outcomes, by enabling investors to make more informed investment decisions.

Aims of this survey

Pension plans are significant investors in the ESG space, as shown by a previous study from CREATE-Research, The next stage of ESG evolution in the pension landscape (2023). Hence, the aim of our 2024 annual survey is to canvass their views on whether these measures will assist capital markets to accelerate the pricing of ESG risks and opportunities and thus have a material impact on their asset allocation decisions.

The survey pursues four questions:
– What is the current status with regard to pricing ESG risks and opportunities?
– What will be the future impact of recent regulatory and policy measures on the pricing process?
– Which aspects of asset allocation are most likely to be affected?
– How will selection criteria for external asset managers change?

These questions were pursued in an electronic survey involving 156 pension plans in 13 key pension markets globally. Their combined AuM was €1.93 trillion. Their background features are given in the two figures to the right.

The survey results were bolstered by 30 structured interviews with senior executives from the respondent organisations. The survey provided the breadth, with the interviews adding depth and insight. Together, they shed fresh light on how pension investors are reacting to the latest wave of regulatory and policy measures. As such, they represent the views of respondent organisations.

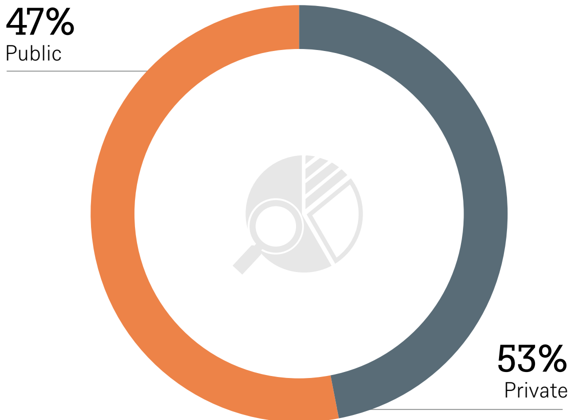
The rest of this section presents our survey highlights, four key findings and the seven themes that support them.

"Regulators and governments can have a big impact in reshaping the ecosystem of capital markets by factoring negative externalities into securities' prices."

An interviewee quote

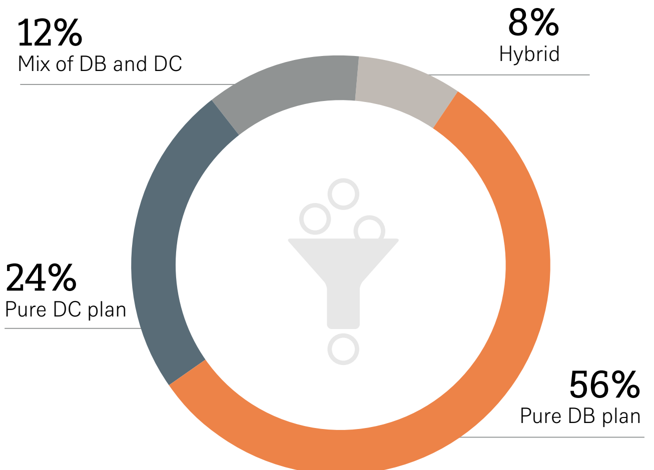
What sector does your pension plan cover?

% of respondents



What is the nature of your plan?

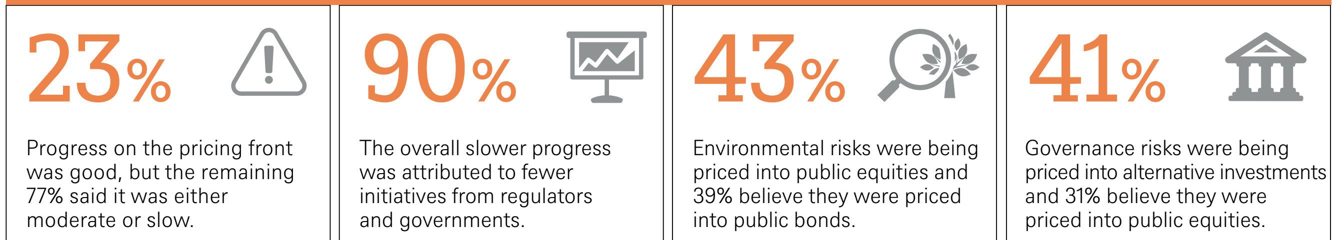
% of respondents



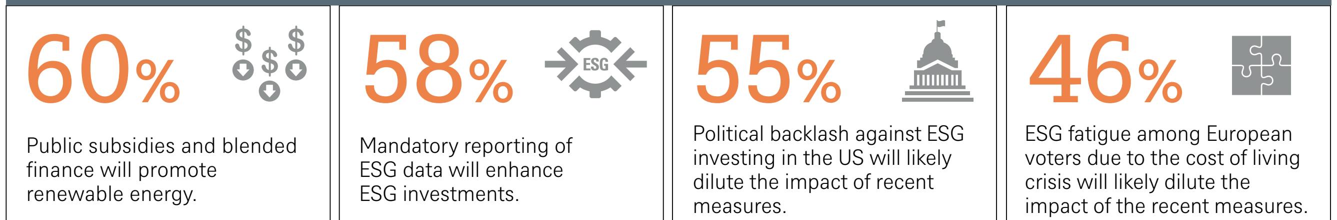
Source: CREATE-Research Survey 2024

Survey highlights (% of pension plan respondents)

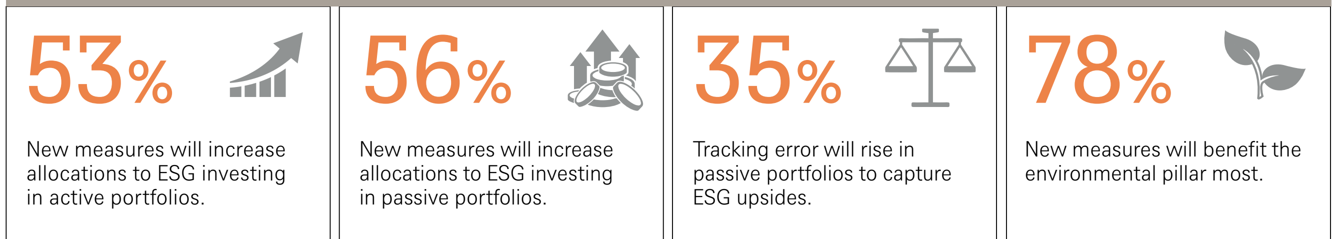
Pricing of ESG risks and opportunities before the new measures



Future impact of new regulatory and policy measures



Aspects of asset allocation most likely to be affected by the new measures



Selection criteria for external ESG managers

"Singly, the new measures may not seem catalytic enough. Together, they may well be quite consequential in hindsight."

An interviewee quote

Four key findings

1. Capital markets have been slow to price in ESG risks and opportunities in the recent past

Substantive ESG regulatory and policy measures have gained traction since the 2020 pandemic. Before then, the pricing of ESG risks and opportunities into securities by capital markets was limited, variable and selective: 30% of our survey respondents saw it as slow, 47% as moderate, 23% as good and 0% as excellent (see Theme 2). There were two causes: market failure and market inefficiency.

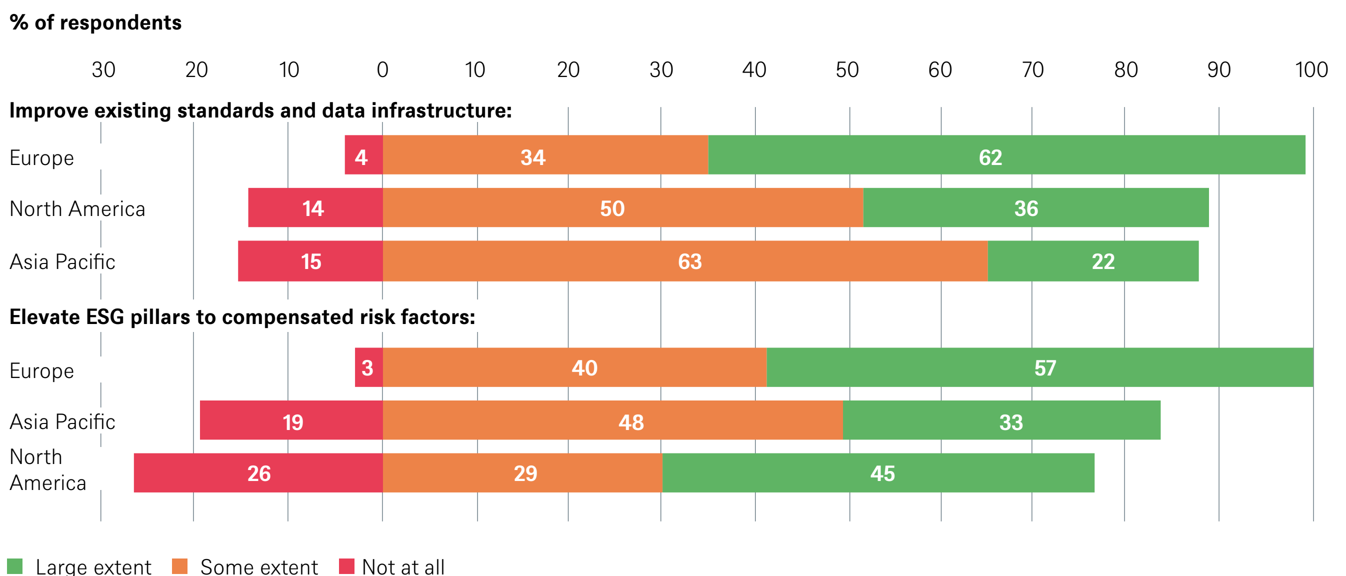
Failure occurred as companies were not penalised for harmful business practices that inflicted uncompensated costs on wider society without hurting their own bottom lines. Regulators and governments were slow to react because of other immediate priorities. They followed the path of least resistance in proactively promoting ESG investing rather than creating incentives and penalties.

Hence, inefficiency occurred as capital markets failed to reward companies with strong ESG credentials until they delivered tangible financial benefits under prevailing accounting rules that ignored negative externalities, such as environmental pollution and lapses in governance structures, directly impacting corporate profitability.

At the time, the issues of failure and efficiency were not seen as vital to ESG investors while capital markets were in the longest bull phase in history, due to easy money policies after the 2008 crisis.

Figure A

To what extent are the two sets of measures below likely to improve the pricing of ESG risks and opportunities in key capital markets in the three listed regions over the next three years?



Source: CREATE-Research Survey 2024

"Climate action versus voters' wallets has become a defining political issue today."

An interviewee quote

But this reversed abruptly with the bear market of 2022, when ESG performance suffered for reasons unconnected with ESG, according to our survey respondents. It drove a decisive shift in ESG investing from quantity (asset gathering) to quality (outcomes). The burden of proof that ESG investing works has since risen exponentially. 'Trust but verify' is the new mantra for pension investors.

More details in Themes 1 & 2

2. New measures have created an impetus for action that are likely to assist the price discovery process

In 2020, the regulatory bandwagon started to roll in earnest with a raft of new rules from regulators in China, Europe and North America. They have clear potential to improve the current infrastructure of ESG data and the reporting framework, while enhancing the integrity of ESG products, the effectiveness of stewardship activities, and the scope for global cooperation towards harmonised ESG standards.

For their part, governments have also been implementing ambitious ESG policy measures that provide capital markets with clear incentives and sanctions for pricing in climate risks and, over time, elevate ESG as a compensated risk factor, while also providing support for communities that are disadvantaged in the process.

The regulatory and policy measures in question fall into two mutually reinforcing groups: those that aim to improve the current infrastructure of ESG standards and data, and those that seek to elevate ESG pillars into compensated risk factors.

Taking a three-year view, their impacts are likely to vary geographically (Figure A). In both groups, Europe is in pole position, followed by North America and then Asia Pacific. The ranking is directly related to the scale and ambition of the measures these regions have enacted thus far in this decade, as shown in Section 2.

These measures mark important steps forward, but they are nowhere near the giant strides the world needs to take to tackle global warming and social inequalities. Yet, they are welcomed by the majority of our survey respondents, who are factoring them into their overall asset allocation. This is in the belief that the capital markets' ecosystem reacts to changes in the rules and policies in fits and starts in the implementation phase. The pricing-in process will be a matter of trial and error and learning by doing.

This fitful journey of adaptive learning may well follow the path of a J-curve after experiencing initial hiccups, as happened with the mass declassification of Articles 8 and 9 funds under the EU's Sustainable Finance Disclosure Regulation (SFDR) during the two tense episodes in 2022-23.

Along that journey, asset returns will continue to be influenced by macro factors like interest rates, inflation, GDP and geopolitical events. These can, and often will, overwhelm idiosyncratic risks that pertain to individual companies, such as ESG. This much was evident from the collapse of the stocks of listed renewable energy companies in 2022-23.

In any event, more immediately, the process of pricing in ESG risks faces headwinds on two fronts (Figure B).

On the political front, there has been a backlash against ESG in the US. There is also ESG fatigue among European voters due to the cost of living crisis sparked by the invasion of Ukraine. Opinion polls show that many voters who support net zero climate measures in an abstract sense drop that support when told that it will bring additional personal cost.

Our world is in the midst of a 'polycrisis', where many intractable and seemingly unrelated events arise at the same time. Markets are likely to remain more unpredictable than usual.

In the meantime, on the implementation front, the new measures risk adding a further dimension of complexity in asset allocation due to uneven

"ESG investing is a fact of life and market pricing is a matter of time."

An interviewee quote

implementation in different regions. Their impacts will be incremental, not immediate.

More details in Themes 3 & 4

3. The measures will have a variable impact on individual ESG pillars and their asset classes and strategies

Far and away, the greatest impact will be felt on the environmental pillar of ESG, as the main thrust of the new measures is directed at tackling the climate crisis.

These were further augmented by the progress made at the Dubai COP28 in four areas: 'loss and damage' fund; pledges made by oil and gas producers to 'transition away from fossil fuels'; a pledge by 120 countries to have a steep increase in renewable energy by 2030; and commitments on energy efficiency.

On the asset class side, the new measures are expected to benefit developed market assets – at least initially. That is because developed market companies embraced the ESG ethos well ahead of their developing market peers, leading to higher ratings on all three ESG pillars. Developing market companies are likely to burnish their ESG credentials to avoid import taxes in Europe and the US that are based on the carbon footprint of imported products.

On the investing side, new measures are expected to enhance ESG outcomes: more opportunities for diversification by sectors, countries and asset classes. They will increase the likelihood of better liquidity, lower volatility and higher returns as ESG risks are duly rewarded by capital markets. Indeed, in the wake of the new measures, ESG is now seen as the biggest driver of change in the ecosystem of capital markets, far surpassing other structural drivers.

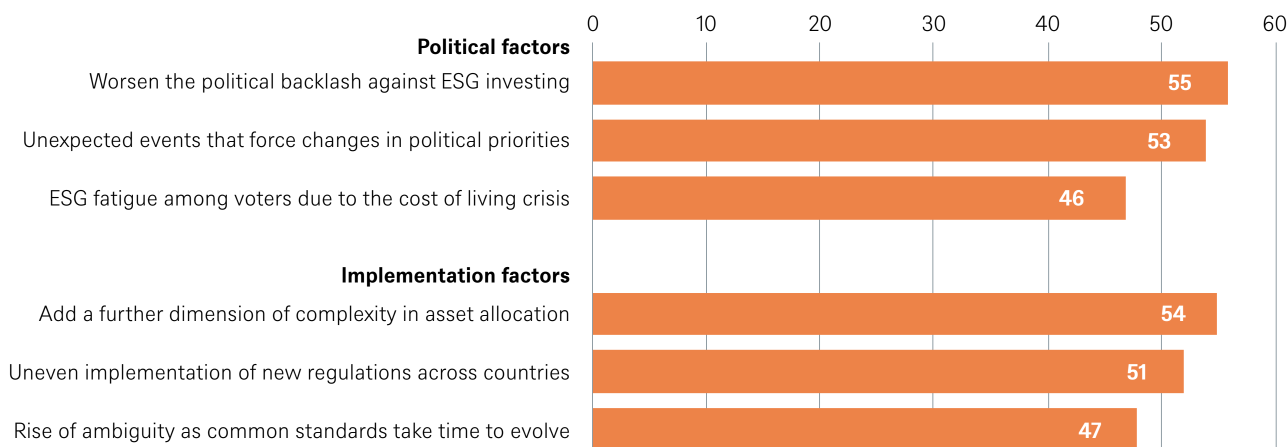
Both active and passive exposures are likely to see higher allocations. Indeed, passives are also likely to see a continuing advance in two new directions: fixed income assets, where the required data on benchmarks and products are becoming more widely available; and a new generation of indices that aim to capture ESG upsides via a higher tracking error against their parent benchmark.

More details in Themes 5 & 6

Figure B

Which factors could undermine the impact of the recent regulatory and policy measures in the near term?

% of respondents



Source: CREATE-Research Survey 2024

"Asset managers must demonstrate that ESG ethos is an essential part of their corporate DNA."

An interviewee quote

4. The manager selection process for ESG mandates is undergoing a makeover

In the wake of the 2022 bear market, the decisive shift from quantity to quality turned the spotlight on the role of asset managers in delivering targeted outcomes.

This is duly reflected in the breadth and depth of criteria now being used by pension plans when selecting their external managers for ESG mandates. Our survey respondents' current ratings of asset managers on the expanded set of criteria reflect ample scope for improvement: 11% are rated excellent, 28% as good, 45% as fair and 16% as poor (see Theme 7).

The expanded list of criteria falls into two clusters: one client centric, one business centric. Within each cluster, some criteria focus on past track record and some on proxy indicators that show whether that record has a high likelihood of being replicated or improved in future.

In the client-centric cluster, the desired track record centres on:
- stewardship, proxy voting and year-round dialogue with portfolio companies
- outcomes on clients' ESG goals
- widely admired thought leadership brand
- political sensitivity in getting across ESG messaging in a balanced way
- a value-for-money fee structure.

In the business-centric cluster, the desired track record centres on:
- insights into how new regulations and public policies affect capital markets and the ESG value chain
- evidence on how core ESG values are embedded in the fabric of the manager's corporate culture and the investment value chain.

Reportedly, the shift from quantity to quality has enough momentum to overcome the tyranny of what has come to be known as path dependency: the bias towards fossil fuels in the current state of knowledge in the energy sector, due to a long history of investment in these areas. The hefty policy push towards renewable energy should create at least a better balance – if not a swing of the pendulum – by 2030.

After all that is happening on the regulatory and policy front, it is hard to believe that the current tailwinds behind ESG investing are likely to ease any time soon.

More details in Theme 7

"In the US, before the Biden administration, there was no environment in which ESG risks were rewarded by capital markets."

An interviewee quote

"If companies had been disclosing the right ESG information, then slower policy action wouldn't have mattered so much."

An interviewee quote

Theme 1

The pricing of ESG risks has been variable and selective

When assessing whether capital markets were pricing in ESG risks and opportunities in earnest since new regulatory and policy measures were introduced in 2020, it is helpful to know our respondents' views on the situation prior to the new measures and the speed of progress since then. The prior situation is covered here, and the speed of progress in Theme 2.

It is clear that the dynamics of the pricing process pre-2020 varied by ESG pillar and asset class (Figure 1.1). Notably, in each of the broad asset classes, more respondents believed that there was more progress in the environmental pillar than in the other two. It was also more widespread in equity markets than in bonds and alternative investment markets. Thus, the pricing process was variable and selective within and between asset classes, 20 years since ESG investing first became popular after a 2004 report from the United Nations titled Who Cares Wins. The main reasons behind these seemingly low numbers were market failure and the market inefficiency prevailing at the time.

Failure, because governments and regulators did not then penalise unsustainable business practices that did not hurt a company's own bottom line, even though such practices inflicted uncompensated costs on society.

It is clear that the dynamics of the pricing process pre-2020 varied by ESG pillar and asset class.

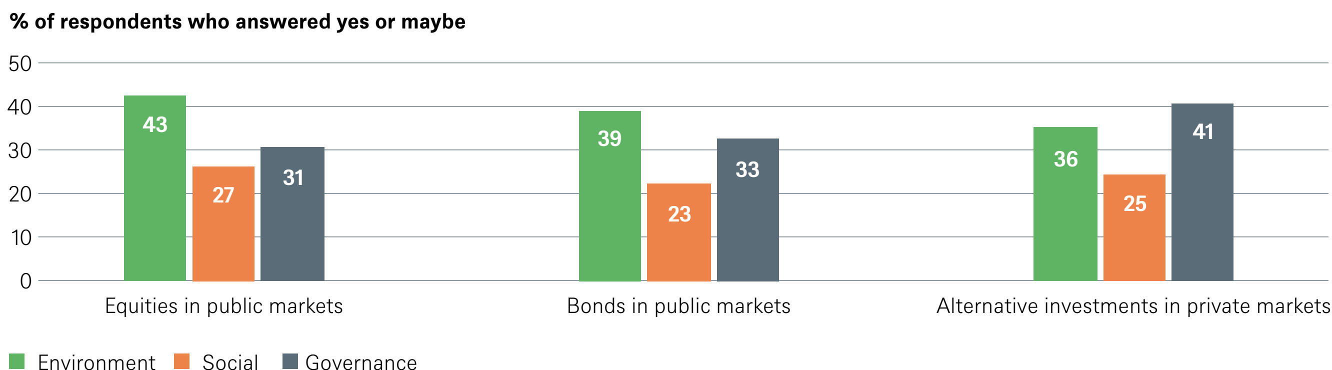
Inefficiency, because capital markets did not duly reward a sustainable company unless it delivered tangible financial benefits based on the prevailing accounting rules that put emphasis on financial considerations to the exclusion of all else. Markets lacked credible signals, without the mandatory disclosure of ESG risks by listed companies.

Although governments and regulators recognised that social inequalities and environmental pollution were the biggest negative externalities, they had been slow to respond, owing to opposition from vested interests. For example, since the 2015 Paris Agreement, policy measures on carbon pricing – covering taxes and emissions trading based on the principle 'let the polluter pay' – have been patchy, signalling virtue rather than value.

Figure 1.1

Pre-Covid, were global capital markets factoring ESG risk and opportunities in the three broad asset classes?

% of respondents who answered yes or maybe



Source: CREATE-Research Survey 2024

"ESG investing thrived in the longest bull market fuelled by easy money policies since 2009. The reversal in 2022 was a moment of reckoning."

An interviewee quote

They had limited success in enticing big corporate emitters to purposively internalise environmental costs into their profit and loss accounts. This omission undermined the price discovery of climate risk, while letting corporates pocket the gains and socialise the costs.

Theme 2

The pricing of ESG risks has been slow in the past

If the pricing process was somewhat limited in scope prior to 2020, so was its pace (Figure 1.2, left chart): 30% of our respondents saw it as slow, 47% as moderate, 23% as good and 0% as excellent.

> The burden of proof that ESG investing works has since risen exponentially.

Yet, this did not deter investors' strong interest in ESG and the UN's Sustainable Development Goals after the 2015 Paris Agreement on climate change. This was helped by the longest bull market in history, which lifted all asset values.

Concerns about whether markets were pricing in ESG risks were nowhere near as high then as they were after the bear market of 2022, as central banks sought to arrest the steep inflation spike from the severe dislocation caused by Covid-19 and the Russian invasion of Ukraine. All asset classes were indiscriminately hit, no matter their intrinsic worth. ESG portfolios suffered for reasons that were unconnected with ESG per se.

Even so, that episode marked a decisive shift from quantity to quality. The burden of proof that ESG investing works has since risen exponentially: pension plans demand ever more transparency in the investment process and its financial and societal impacts. Lately, this shift has received fresh impetus from regulators and governments with a raft of changes unprecedented in scope and speed (see Section 2). Before then, they were held responsible for slow progress (Figure 1.2, right chart), with 58% saying it occurred to some extent and 32% saying that it was to a large extent. But they had their own challenges.

On the regulatory side, the main problem was a conceptual one, encountered in attempting to develop credible actionable ESG metrics, in the absence of an agreed definition of sustainability. Another problem was the absence of reliable forward-looking decision-useful data, verified by a third party and comparable across geographies and timeframes. Some data pay no regard to the inherent trade-offs between the E, S and G pillars.

On the government side, the main challenge was how climate action can cause socio-economic upheaval in local communities by turning carbon reserves into stranded assets with premature write-downs well ahead of their economic lives. Lobbying by vested interests proved all too effective in blocking progress on this front.

"Many influential political leaders believed that capital markets, not governments, were better able to address ESG issues."

An interviewee quote

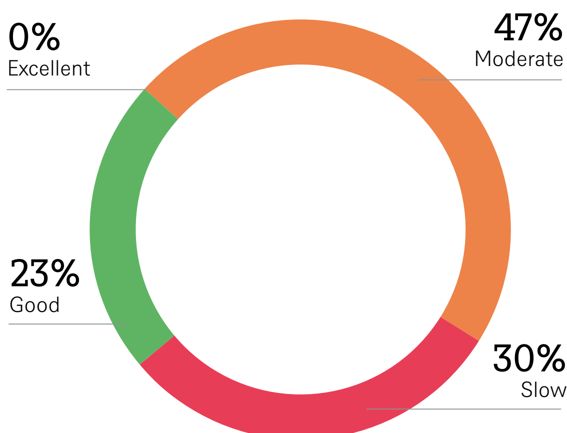
"ESG investing thrived in the longest bull market fuelled by easy money policies since 2009. The reversal in 2022 was a moment of reckoning."

An interviewee quote

Figure 1.2

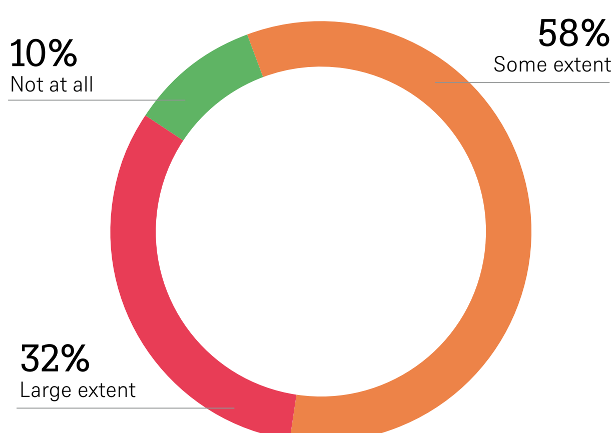
Overall, how would you describe the pace of capital markets' pricing of ESG risks and opportunities before new measures were introduced?

% of respondents



If your answer is 'slow' or 'moderate', to what extent is that due to regulators/governments being too slow to implement new policies in the past?

% of respondents



Source: CREATE-Research Survey 2024

Theme 3

The new measures are likely to drive fresh ESG allocations

The regulatory overdrive and fiscal boost described in detail in Section 2 is likely to enhance the price discovery of ESG risks and opportunities. As such, they are expected to influence pension plans' allocation to ESG investments to varying degrees (Figure 1.3, left chart): 29% said that they will to a large extent, 51% said to some extent and 20% said not at all.

First, the regulatory bandwagon is rolling in earnest with a raft of new rules in China, Europe and North America. They have clear potential to improve the current infrastructure of ESG data and reporting frameworks, while enhancing the integrity of ESG products, the effectiveness of stewardship activities, and the scope of global cooperation towards harmonised ESG standards. In this context, the EU's CSRD marks a giant step forward.

Second, governments are introducing ambitious ESG policy measures that signal clear incentives and sanctions for pricing in ESG risks and elevate ESG as a compensated risk factor, while also supporting communities that are unduly hit in the process. The Inflation Reduction Act in the US and the Green Deal Industrial Plan in the EU are unparalleled in ambition and action.

"Many influential political leaders believed that capital markets, not governments, were better able to address ESG issues."

An interviewee quote

"By themselves, capital markets can't seem to find direction in ESG without hard incentives and sanctions."

An interviewee quote

As a result of these measures, ESG factors are finally likely to become part of strategic asset allocation (Figure 1.3, right chart) and offer a higher degree of flexibility and customisation. The process has been very gradual, however, since more time series based evidence is needed than is currently available to show that ESG is indeed a compensated risk factor. But as and when new measures increasingly influence the price discovery of ESG factors, ever more pension plans expect to build ESG into their strategic asset allocation and move to ESG indices as their policy benchmark. That way, ESG investing will no longer be constrained by traditional market benchmarks. Progress, however, will be incremental, especially with the environmental pillar.

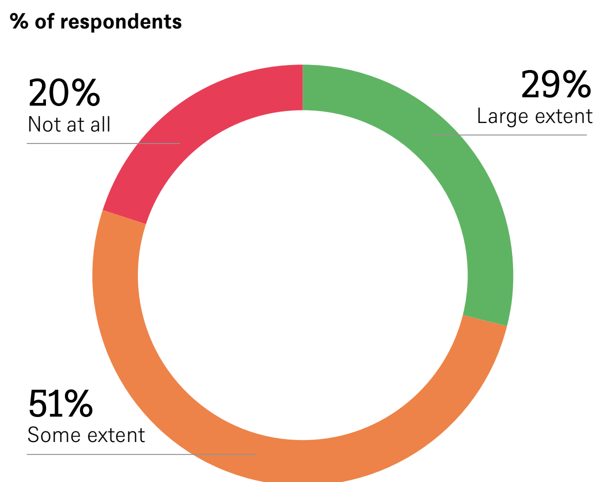
This is because the current state of knowledge in the energy sector is biased towards fossil-fuel technologies, owing to a history of investment in these areas. The shift to renewable energy requires a tax on the use of carbon and public subsidies for green energy. But some of the new measures on the tax front are not, as yet, ambitious enough (see Section 2).

The Inflation Reduction Act in the US and the Green Deal Industrial Plan in the EU are unparalleled in ambition and action.

Figure 1.3

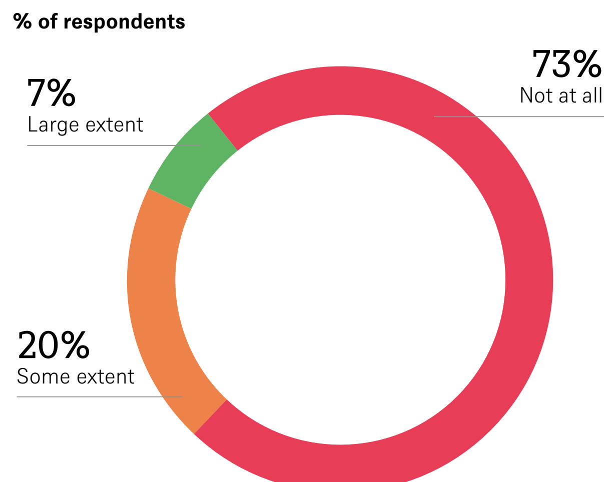
To what extent are regulators and governments likely to be among the key drivers of your pension plan's allocation to ESG investing over the next three years?

% of respondents



To what extent will ESG factors become part of your strategic asset allocation as a result of new regulatory and policy measures?

% of respondents



Source: CREATE-Research Survey 2024

"The fact that the top 15 carbon-polluting countries have adopted net zero carbon targets is significant."

An interviewee quote

"The International Sustainability Standards Board has made big strides towards tackling the alphabet soup of standards."

An interviewee quote

Theme 4

The new measures are likely to affect markets via adaptive learning

When asked whether our survey respondents' asset allocation now takes into account new ESG regulations and policies, 15% said not at all, 56% said to some extent and 29% said to a large extent (Figure 1.4, left chart). However, this latest wave of measures is seen as marking a series of small steps rather than one giant leap, for three unrelated reasons.

First, on the environmental side, there remains ample scope to improve the efficacy of carbon pricing to curb carbon demand and the adoption of energy standards to curb fossil fuel supply, and to introduce new measures to reduce the financed emissions of the banking and insurance sectors. Since it is vital to put a price on nature to save it, forward guidance on carbon pricing is also vital.

Second, as shown in Section 2, ESG is now facing headwinds from unfamiliar forces such as the political backlash in the US, the Russian invasion of Ukraine, and ESG fatigue from voters in Europe due to the current cost of living crisis. Until there is some clarity on their end game, 'wait and see' is likely to dominate investor thinking.

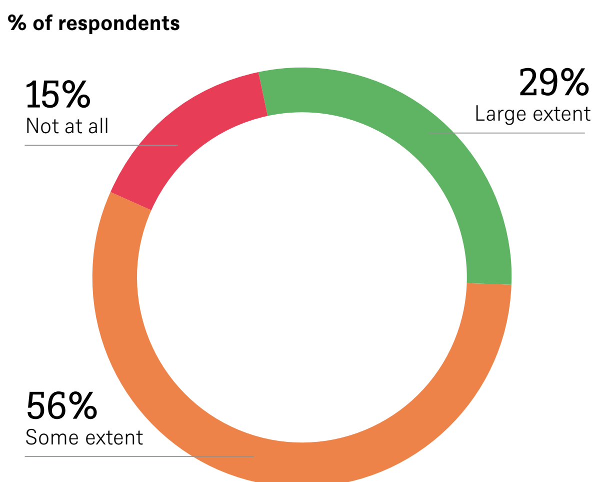
Finally, many of our respondents believe that capital markets don't take an analytical approach when it comes to adapting to new regulations and policies, but do so by trial and error, thus enabling the development of simple rules of thumb that evolve into new heuristics, displacing old ones incrementally over time. To underline that point, these respondents now follow ESG-related measures in comparison with other measures to some extent (53%) or to a large extent (37%), as shown in Figure 1.4, right chart.

This is because the majority of our respondents participating in the post-survey interviews see

Figure 1.4

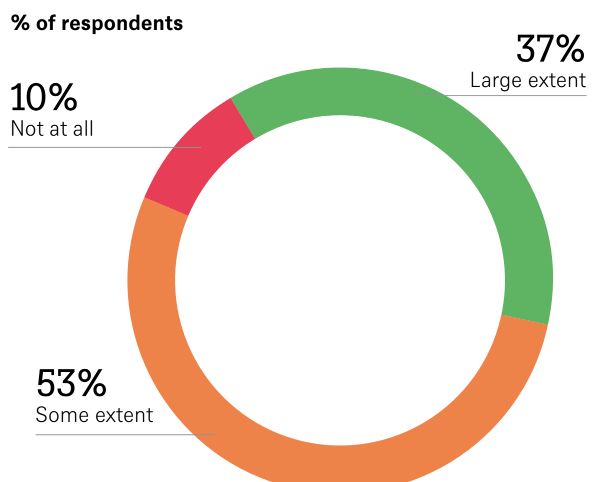
To what extent do you take into account ESG-related regulations and public policies in your overall asset allocation?

% of respondents



To what extent do you consider ESG-related regulations and public policies in comparison to other regulatory and policy factors?

% of respondents



Source: CREATE-Research Survey 2024

"The new rules that Australia, Canada, the EU and the US are imposing on imports tied to child labour are long overdue."

An interviewee quote

New ESG measures are seen as the biggest driver of change in the ecosystem of capital markets, surpassing other structural drivers.

the new ESG measures as the biggest driver of change in the ecosystem of capital markets, surpassing other structural drivers. One example is the latest mandatory disclosure rules in China, which apply to over 400 of the biggest companies, effective from 2026. They have to disclose their ESG governance and strategy, along with metrics including their energy transition plans and the impact they are likely to have on the environment and society. Lack of compliance is viewed as an infringement of public interest and could result in forced delisting. Another example is the latest rule from the US Securities and Exchange Commission on the mandatory disclosure of climate risks.

Theme 5

Love it or hate it, ESG is here to stay

Climate action is gaining traction, as reported by The European Electricity Review published by the think tank Ember: renewables account for 44% of the continent's electricity. It also shows a 26% and 15% decline in coal and gas power generation, respectively, in 2023. If these trends continue, the report states that it is highly likely that global emissions will start falling this year, making 2023 their peak year. Investors are duly taking note.

As shown in Section 4, in 43% of active portfolios – where pension investors first started investing in ESG factors – the current share of ESG allocations is over 20%. The similar figure for passive portfolios is 28%, as the arrival of the ESG indexes promoted a catch-up. The recent measures are set to boost these numbers (Figure 1.5): 53% of our respondents expect to increase ESG allocations in their active portfolio and 56% in their passive portfolio.

The boost from the recent measures will enhance the price discovery of ESG risks and opportunities, as shown in Section 3. It will likely improve investment outcomes in areas like diversification, volatility, liquidity and returns. In the process, all broad asset classes are expected to benefit, with three types of bonds set to drive the biggest social and environmental change: social bonds, that target positive social outcomes, green bonds that target decarbonisation and sustainability-linked bonds that target specific social or climate outcomes. The ESG credentials of the issuers now influences their creditworthiness.

The boost from the recent measures will enhance the price discovery of ESG risks and opportunities.

"We prefer active funds for both bond and equity investing because of the shareholder activism they permit."

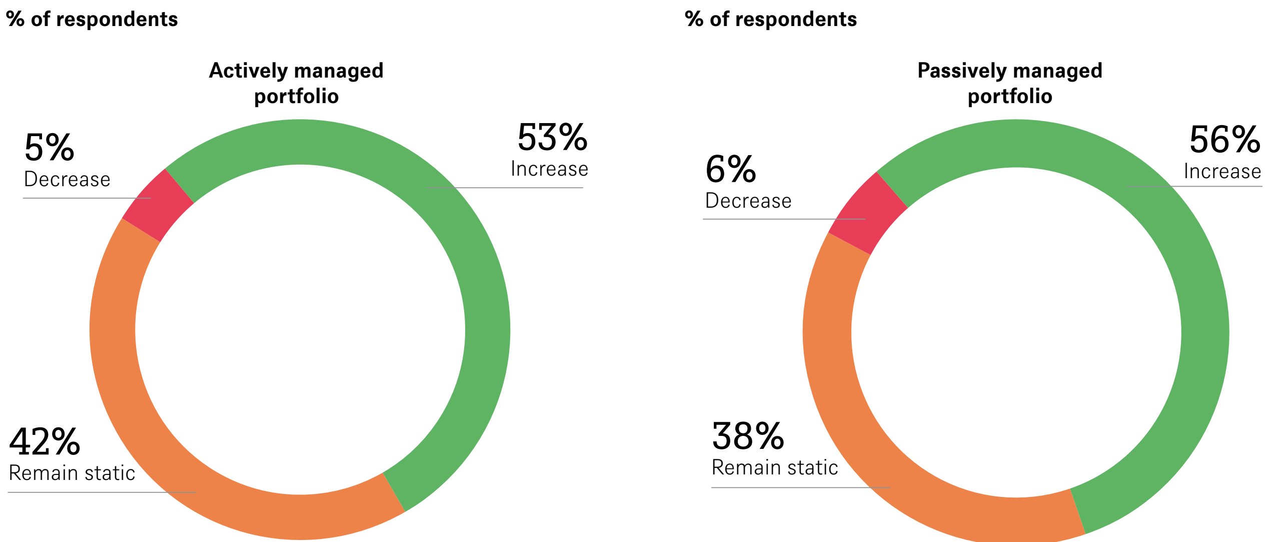
An interviewee quote

Equities too are set to benefit, as their artificially inflated prices reconnect with their fundamentals, after years of cheap money policies. Alternative investments, for their part, typically have small allocations to ESG. But these are set to increase when new blended finance projects envisaged under new policy measures offering concessionary finance take off. Two other developments are likely, both pertaining to passive exposures.

First, the stunning advance of passive allocations in equity portfolios of the past twenty years is likely to be repeated for passives in bond portfolios, as required data on the benchmarks and products have finally become more widely available. Second, there has been a proliferation of new ESG indices, with a higher tracking error against their parent benchmarks. The boundary between active and passive exposures is blurring. This has enabled pension plans to use passives for impact investing in general and the UN's Sustainable Development Goals in particular. Impact investing aims to deliver ESG as well as financial benefits.

Figure 1.5

How are recent measures likely to influence the current allocations of ESG-related funds in your pension plan's two portfolios over the next three years?



Source: CREATE-Research Survey 2024

"Critics who questioned whether the best choice is to abdicate choice remain confounded by the relentless rise of passives."

An interviewee quote

"The new generation of ESG indices have a higher tracking error in order to capture maximum upside."

An interviewee quote

Theme 6

Higher tracking error is becoming the norm

The immediate aftermath of the Paris Agreement saw the rise of passive portfolios that followed one or more of the ESG pillars while strictly tracking their parent indices, giving rise to a paradox. On the one hand, our survey respondents saw ESG investing as a long-term story offering good risk-adjusted returns. On the other hand, they were not willing to tolerate a high tracking error that led to marked deviations from the parent index used as a benchmark in the interim.

At the time, this seeming contradiction was explained by the fact that our survey respondents saw a low tracking error as setting only baseline return expectations in line with the chosen parent index.

However, by reorienting their portfolios to include companies with high or improving ESG scores, our respondents expected to see an asymmetric pay-off: a clear upside, without sacrificing baseline outcomes. Thus, they were seeking a free option on ESG if markets started to price in ESG risks in earnest, and minimise downside risk of capital loss if they did not.

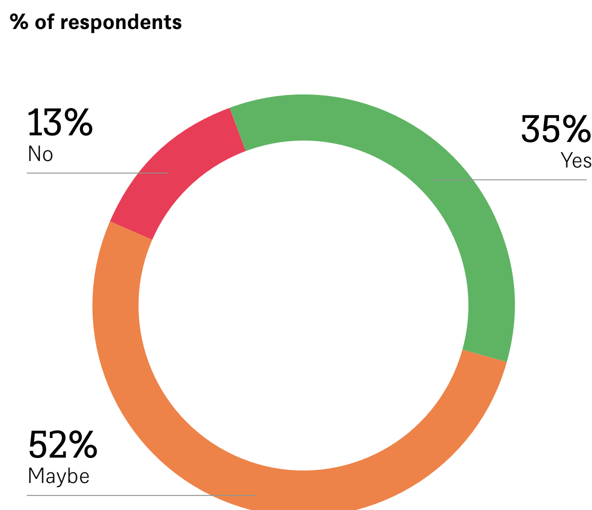
Since then, however, as pension investors have progressed up the learning curve, the tolerance level has risen somewhat, in part at least aided by the recent regulatory and policy changes. These are perceived as improving the price discovery of ESG risks and improve the implied risk–return pay-off, according to 35% who said yes and 52% who said maybe (Figure 1.6, left chart).

Currently, 54% are content with a tracking error of less than 1%, 31% are content with one between 1% and 2.9%, and 15% are content with an error of 3% and above (Figure 1.6, right chart).

Figure 1.6

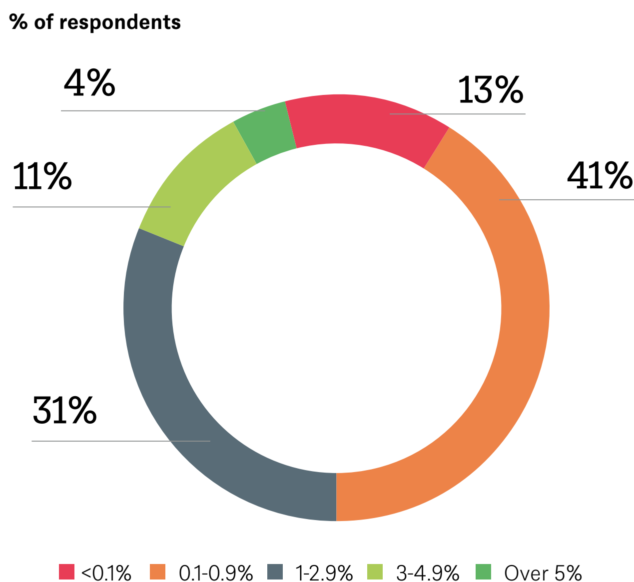
Will the new measures encourage your pension plan to adopt a higher tracking error (deviation from the parent index) in your ESG-related passive funds?

% of respondents



What is the extent of the tracking error that your pension plan is willing to accept in your ESG-related passive funds under the new measures?

% of respondents



Source: CREATE-Research Survey 2024

"Active–passive is becoming more blurred with factor-based strategies like smart beta."

An interviewee quote

Many among those content with a tracking error of over 1% are focusing on the UN's Sustainable Development Goals and their double materiality target.

Many of those content with a tracking error of over 1% are focusing on the UN's Sustainable Development Goals and their double materiality target, according to our post-survey interviews. This enjoins investors to look beyond the impact of ESG risks on their portfolios to assess how their investee companies' own activities affect external social, economic and environmental systems.

Even those who are seeking only decent financial returns recognise that a higher tracking error is a prerequisite.

Theme 7

Stewardship is seen as the linchpin of ESG investing

As ESG investing hit turbulence in 2022-23, the spotlight turned on the role of asset managers in delivering targeted outcomes, as part of the shift from quantity to quality. Evidently, there is ample room for improvement in managers' current rating (Figure 1.7, left chart): 11% are rated as excellent, 28% as good, 45% as fair and 16% as poor.

Step improvements are called for in five key areas of managerial activities. The first is constructing an ESG narrative around the new measures and aligning it with their clients' goals. The second is ensuring that all senior executives in the business champion ESG values by setting the tone and example that cascade into the manager's business culture and operations. The third is using stewardship, i.e. engagement and proxy voting as key drivers of ESG progress on the ground. The fourth is differentiating their products and performance as part of a value-for-money fee structure. The fifth is enhancing the integrity of their products carrying ESG labels by developing data and reporting systems that minimise product mislabelling.

As shown in Section 5, stewardship track record is a top line issue in manager selection. This applies to passive portfolios as much as active ones (Figure 1.7, right chart).

Passives are no longer perceived as lazy owners of companies, allowing their managers to pursue

Step improvements are called for in five key areas of managerial activities.

"ESG investing was born in a bullish era, and has come of age in a challenging era. It is making new demands on asset managers."

An interviewee quote

"The index is not a fiduciary, but its managers are. Without active stewardship, they will lose relevance in this era of higher tracking error."

An interviewee quote

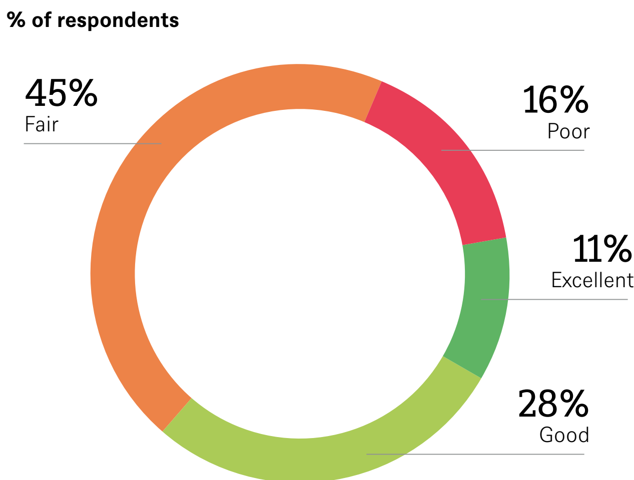
their own agenda at the expense of the interests of wider society. The reason is that passive managers cannot divest their positions in poorly performing companies. Being the ultimate long-term investors, they have every incentive to use stewardship as a tool to improve the quality of their beta assets. All the more so since pension investors are now moving towards higher tracking error mandates in their ESG investing, as shown in Theme 6.

Hence, the recent back-sliding on activist shareholder proposals by large US asset managers due to the recent political backlash is a matter of grave concern, as is the growing number of large US asset managers pulling back from the prominent advocacy group Climate Action 100+ in the face of spurious campaigns against 'woke capitalism'. Our respondents remain concerned and they expect reason to prevail before long, according to our interviews.

Figure 1.7

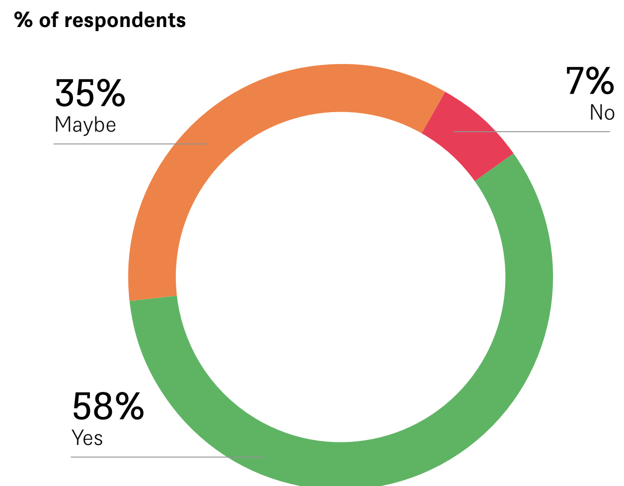
How do you rate the asset managers who are given your pension plan's current ESG mandates?

% of respondents

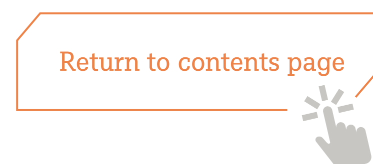


Will stewardship and proxy voting continue to be just as relevant to passive portfolios as they are to active portfolios?

% of respondents



Source: CREATE-Research Survey 2024



2

Recent regulatory and policy measures: What are their key goals?

"Regulators and governments have delivered more than expected but less than needed."

An interviewee quote

Overview

This section highlights the key ESG-related regulatory and policy measures enacted since the 2020 pandemic. It addresses three questions:
- What is the scope of regulatory measures and what are their aims?
- What is the scope of policy measures and what do they aim to achieve?
- Which hurdles are likely to ensure that the impacts of these measures will be incremental, rather than immediate?

Key findings

a. Regulatory measures

The ESG regime has been bolstered by two distinct sets of measures. The first set aims to improve:
- the quality of data used by investors in their pension portfolios
- the standards with common definitions and reporting frameworks
- product integrity that seeks to ensure that an investment product delivers what it says on its label.

The second set aims to improve:
- the effectiveness of stewardship, engagement and proxy voting
- international cooperation between regulators in order to achieve standardisation
- the alignment between executive incentives and ESG goals of portfolio companies.

b. Policy measures

Two sets of measures have been enacted. The first set focuses on fiscal measures that are expressly designed to:
- hasten the energy transition via big investments in renewable energy
- achieve a just transition by protecting communities and sectors that are adversely affected In the process.

The second set focuses on institutional mechanisms that aim to reduce carbon emissions by:
- setting emission standards for energy utilities
- carbon pricing that taxes consumption based on the 'let the polluter pay' principle
- revising the fiduciary duty of pension investors.

c. Hurdles to speedy progress

Regulatory and policy measures face twin challenges. The first is political:
- the ESG backlash in the US
- geopolitical events forcing changes in the political priorities of national governments
- ESG fatigue among voters, particularly in the EU
- changes in governments due to the election super cycle in 2024
- higher interest rates if climate transition proves overly inflationary.

"For too long, voluntary corporate data on ESG risks have been self-selected, self-serving and unreliable."

An interviewee quote

"The SDR in the UK address sustainability more broadly and embrace the reporting standards of the ISSB."

An interview quote

The second challenge centres on implementation issues:
- the uneven ways in which measures will be implemented worldwide
- transitional ambiguities as new standards take time to evolve
- the risk of a one-size-fits-all approach stifling innovation.

Key message

Overall, these two sets of measures are mutually reinforcing in their impacts. According to our interviews, they mark important steps forward, but do not constitute the giant strides needed to tackle global warming and social inequalities. Still, they are expected to positively impact the market pricing of ESG risks and opportunities.

The regulatory bandwagon is rolling

Ever since the 2015 Paris Agreement prompted ESG mandates, there has been a yawning gap between what ESG data investors need and what the market provides. That mismatch is expected to ease, as there is now greater certainty about many core aspects of the ESG regulatory regime in the key pension markets. The focus is on the definition of ESG in terms of scope, objectives and outcomes, backed by decision-useful data. The regime has been bolstered by two distinct sets of measures (Figure 2.1).

The first set covers data, standards and product integrity. Top of the list is the mandatory reporting of ESG risks to enhance the credibility of ESG data (58%). One example is the UK Financial Conduct Authority now requiring mandatory climate-related disclosures, using the template from the Task Force on Climate-related Financial Disclosures (TCFD). A similar rule has been adopted in New Zealand too. Yet another example is the EU's Corporate Sustainability Due Diligence Directive (CSDDD), which forces large companies to reduce the negative impacts on climate and human rights, while improving their disclosures on these fronts. The SEC in America has now finalised its own rules on climate risk disclosure, albeit in a diluted form. However, mandatory data are only as good as the standards framework on which they are based.

The focus is on the definition of ESG in terms of scope, objectives and outcomes, backed by decision-useful data.

Progress made by the International Sustainability Standards Board (ISSB) towards the harmonisation of various reporting standards of recent years is also seen as an advance (55%).

In turn, progress in the disclosures that enhance product integrity have seen new measures on both sides of the Atlantic (47%). Notable among them are: the SFDR and the Green Claims Directive in the EU; the Sustainability Disclosure Requirements (SDR) in the UK; and the revision to the 'Names Rule' under the Investment Company Act of 1940 in the US. In each case, regulators have aimed to avoid being too prescriptive, but to address the prevailing information asymmetries (SFDR), investor detriment (SDR), and gaps in decision-useful data (Names Rule).

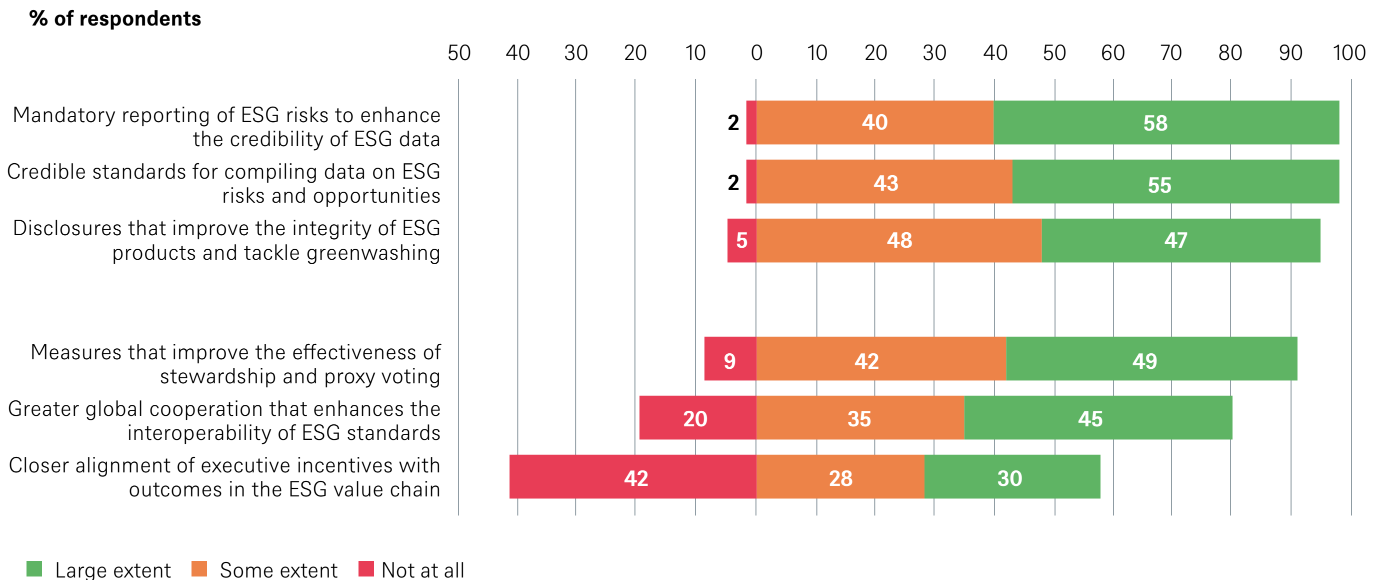
Moving on to the second set of measures, those that improve stewardship top the list (49%). Three such measures merit special mention. First, China's banking and insurance regulator now mandates

"Risk mitigation and impact are two different things.
All the available data focus on the first. Investors focus on the second."

An interviewee quote

Figure 2.1

What types of recent regulatory measures on improving ESG standards and data infrastructure are likely to help your pension plan's decisions on ESG investing?



Source: CREATE-Research Survey 2024

banks and insurers to support the green economy, with a focus on real world outcomes and stewardship. Second, under the revised version of the Names Rule in the US, those labelled as focused ESG funds are expected to have policies on engagement with the issuers – on proxy voting – in support of ESG-related activities. Third, the EU's CSRD envisages stewardship as playing a key role in ensuring that the targeted companies disclose their climate transition plans, ensuring that their business model and strategy are aligned with them under EU climate law (see INSIGHTS on the next page).

Yet another measure that is seen as a positive step is the greater global cooperation that enhances the comparability of ESG standards (45%), as revealed by two examples. First, the EU–China 'Common Ground Taxonomy' aims to improve the future interoperability of their respective green taxonomies. It forms the basis for much-needed harmonisation on green projects, green assets and the definitions of associated activities across the globe. Second, the SFDR, the SDR and the Names Rule are not fundamentally inconsistent, despite their seeming differences. Each aims to take account of the unique features of their respective jurisdictions so as to gain local relevance and legitimacy.

The final measure seeks a closer alignment of executive incentives with ESG outcomes (30%). It is implicit in the new rules on the corporate governance of ESG risks and opportunities, and is explicit in the CSRD in the EU.

So much for the key measures. None is seen as a panacea. Each has its own merits as well as limits, as shown by the recent embarrassing debacle around the SFDR owing to ambiguity in the operational definition of 'sustainability'. They aim to advance the ESG agenda via learning by doing and revising rules in light of new information. Notably, regulators are wary of being too prescriptive or

"Many current concerns about ESG boil down to definitions of what 'sustainability' means at operational level."

An interviewee quote

"2022 was the turning point when governments finally went from promises to action."

An interviewee quote

unduly burdensome to avoid causing 'reporting fatigue'. They have also started with voluntary measures as a stepping stone to greater compulsion over time.

Regulators are wary of being too prescriptive or unduly burdensome to avoid causing 'reporting fatigue'.

Insights

CSRD marks a giant step towards ESG data disclosures

The EU's Corporate Sustainability Reporting Directive has no parallels as yet. It seeks to enhance the corporate disclosure of ESG risks and opportunities (especially related to climate), facilitate data comparability between geographies and ESG pathways, and improve the coverage and quality of ESG products. In the process, it seeks to ensure that ESG strategies remain true to their objectives. Over time, more than 50,000 large companies will be obliged to report on the impact of climate change on their business and the impact of their own operations on the environment under double materiality rules. Thus far, providers of ESG data have focused on how ESG risks affect a company's business (single materiality) and ignore the negative externalities – such as pollution and human rights – associated with its operations.

Just as significant is the wider context in which CSRD will operate. The EU Taxonomy regulation of 2020 sets out a unified classification system that defines environmentally friendly economic activities. The alignment of portfolios to taxonomy is at the heart of the SFDR. It is also at the heart of the previous Non-Financial Reporting Directive which is now expanded in scope under the CSRD, requiring companies to declare their transition plans and the actions being taken to achieve them.

For its part, the European Central Bank also plans to make compliance central to its tolerance of collateral. Thus, CSRD interacts with a number of other initiatives to deliver holistic impacts.

A Swedish plan

Policymakers are also moving up a gear

The past four years have seen the most ambitious government policy measures to date (Figure 2.2). Some are fiscal in character and are designed to hasten the energy transition while protecting vulnerable communities; others are institutional mechanisms aimed at curbing carbon emissions while also promoting green energy.

Taking them in turn, fiscal measures that promote green energy via subsidies and blended finance to a 'large extent' top the list (60%), as 140 countries have adopted or are supporting the net zero by 2050 goal (51%). Two transatlantic initiatives stand out.

In 2022, the US planted a flag with its landmark Inflation Reduction Act. It aims to close two-thirds

"The EU's Carbon Border Tax will have big impacts on emerging market companies unless they reduce their carbon footprints."

An interviewee quote

of the gap between the nation's current policy and the 2030 target. By unleashing $369 billion of tax incentives, it will leverage $1.4 trillion of private capital to spark innovation in green technologies. Canada, too, is catching up with its southern neighbour with its own green tax credits, making it the second-most attractive market for renewable projects behind the US.

EU policymakers followed suit by launching the Green Deal Industrial Plan to boost Europe's net zero industry to hasten the path to climate neutrality. The plan is being driven by two laws passed in 2022: the Net Zero Act and the Critical Raw Materials Act. Both aim to promote clean technologies and green jobs.

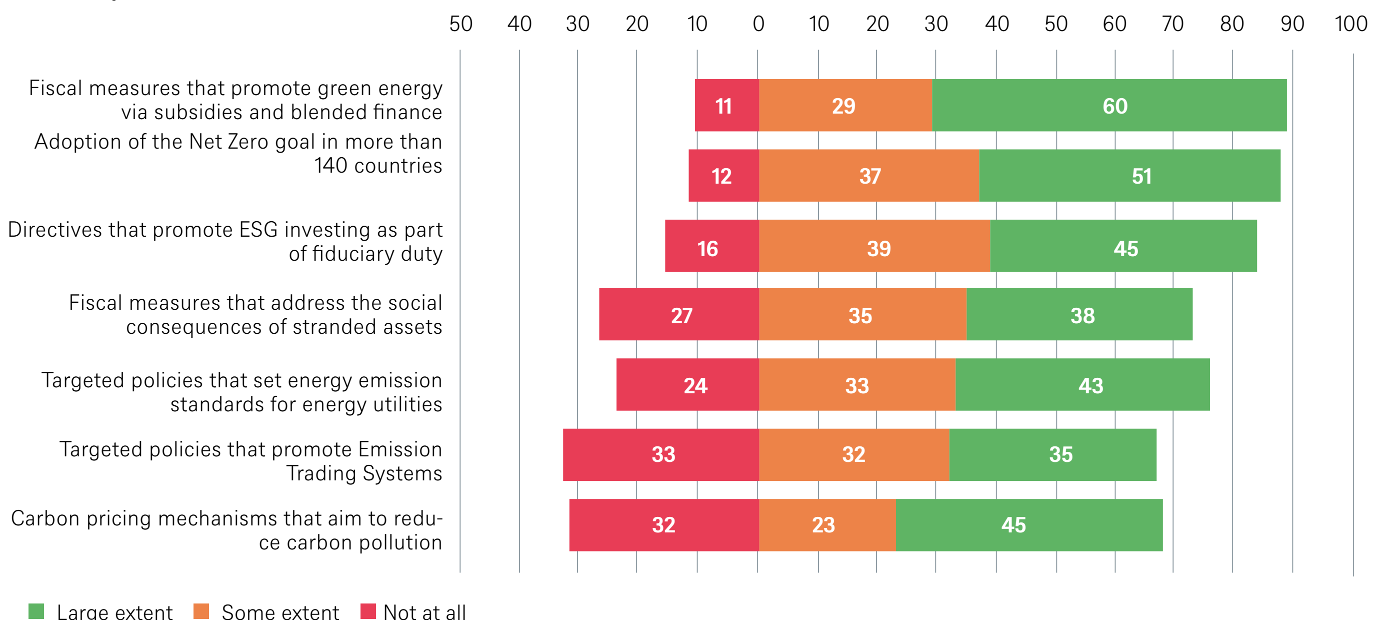
These measures are part of the 'Fit for 55' programme designed to cut greenhouse gas (GHG) emissions while also supporting the most vulnerable citizens and sectors via the new Social Climate Fund. Towards that end, the EU has also introduced a tax under the Carbon Border Adjustment Mechanism, targeting imports of iron, steel, aluminium, fertiliser, electricity, cement and hydrogen. The aim is to protect domestic industries against regulatory arbitrage that promotes the relocation of their production base to countries lacking robust climate policies and encourages them to develop regulated carbon markets. The US has also responded with The Prove It Act – to measure the carbon emissions of

> In 2022, the US planted a flag with its landmark Inflation Reduction Act.

Figure 2.2

Which of the recent policy measures to promote ESG adoption are likely to help your pension plan's decisions on ESG investing?

% of respondents



Source: CREATE-Research Survey 2024

"Progress on carbon taxes has been slow because it hits voters' wallets. Voters want a green economy but don't want to pay for it."

An interviewee quote

"As a legal concept, fiduciary duty remains woolly when applied to pension investors."

An interviewee quote

certain goods in the US and other nations. Both will hit the exports of emerging market companies with high carbon footprints to the EU and the US.

Other global devices have been created, notably in China and Australia, with the former building a carbon footprint management system for 50 products by 2025, as part of a broader advance (see INSIGHTS on the next page). One of the aims is to address the adverse social impacts of stranded assets, as their economies implement the net zero goal (38%).

Turning now to institutional mechanisms, progress is evident but slower than anticipated in four key areas. The first aims to set emission standards for energy utilities (43%). Although widely greeted, they have been vulnerable to legal challenge. The US Supreme Court ruled in 2022 that the Environmental Protection Agency lacked the authority to place a limit on GHG emissions from utilities; paving the way for future lawsuits and galvanising opposition to the SEC's new climate disclosure rule.

The second set of mechanisms relates to carbon pricing that aims to reduce carbon consumption (45%). This remains the most powerful tool to curb emissions and support the energy transition. But as a recent OECD report shows, only 16% of GHG emissions among 72 countries were priced over the €30 benchmark in 2021. The reason is that the price is not high enough to move the needle. Indeed, the same observation applies to the third set of institutional mechanisms, Emission Trading Systems (35%). Again, the same OECD report shows that global coverage of carbon emissions was only 27%. On the positive side, the EU Emissions Trading System plans to cover new sectors like maritime transport and international aviation. A new trading system is now also being created for sectors like road transport and buildings.

The final set of mechanisms covers directives that encourages pension plans to invest in ESG factors as part of their fiduciary duty (45%). They apply to the duty of asset owners to responsibly look after their members' money in the narrowest sense by delivering maximum financial return. Regulators are now moving towards a wider goal that includes ESG impacts. Yet, considerable regulatory ambiguity remains as to whether pension investors should max out returns each financial year or protect value over decades by guarding against risks linked to the energy transition. A UN PRI report covering 11 key fund markets – as diverse as Canada, China and the UK – shows that regulators regard financial return as the primary aim of investors, with only vague pleas on delivering ESG impacts.

Overall, fiscal measures are in the ascendancy and institutional ones remain in catch-up mode at variable speeds. Yet, both sets share a common direction of travel and end goals.

Fiscal measures are in the ascendancy and institutional ones remain in catch-up mode.

"It takes time for regulation to create the impetus for action on the ground that generates market signals."

An interviewee quote

"Never in history has the world economy tried to go green at record speed before. Climate politics is hard and bitterly contested."

An interviewee quote

Insights

Chinese authorities are advancing on a broad front

China is by far the world's biggest polluter, responsible for nearly 30% of carbon emissions, while pursuing high economic growth to lift nearly 700 million citizens out of poverty.

Lately, it has also introduced a raft of measures in pursuit of its twin climate goal: peak carbon emissions by 2030 and net zero by 2060.

It has recently released its green bond principles, aiming to align them with international principles and thus attract more global capital. Its green bond market has come from nowhere to become the largest in the world, growing at a CAGR of 14%.

Separately, banking and insurance entities are now mandated to adopt strategies and capacity to reduce the carbon intensity of their emission-financed asset portfolios in an orderly manner to meet the Net Zero goal. In addition, four regulatory authorities and the People's Bank of China have issued the 14th Five-Year Plan for standardisation as a key pillar of green finance. The resulting surging wind and solar power growth is expected to push fossil fuels to the brink of structural decline in the power sector.

That apart, two exchanges – the Shanghai Stock Exchange and the Shenzhen Stock Exchange – now require the annual disclosure of corporate social responsibility policies and practices in order to promote dialogue between companies and their investors. Failure to comply is seen as an infringement of public interest, resulting in forced delisting.

The Hong Kong Stock Exchange also now requires ESG information to be published alongside annual financial reports. Climate-related information will soon be required to follow the TCFD template.

A Hong Kong SAR pension plan

Regulatory and policy progress face headwinds

Welcome though progress on regulatory and policy fronts is, pension plans recognise that having these measures in place is one thing, getting the best outcomes is quite another.

A number of political and implementation barriers could undermine their impact in the near term before recent progress hastens the pricing in of ESG risks and opportunities by capital markets (Figure 2.3).

On the political side, the backlash against ESG investing in the US tops the list (55%). The nation is experiencing an increasingly divided policy environment (see INSIGHTS on page 28).

Drastically different ESG approaches between Democratic and Republican states are raising legal, reputational and investment risks for pension investors in what is by far the biggest pension market in the world. The anti-ESG movement had a major negative impact in the area of proxy voting in 2022-23 (see Section 5).

Energy security and affordability has triumphed over climate action.

> "Capital markets are adaptive mechanisms and respond to policy changes as credible signals are generated."

An interviewee quote

Unexpected geopolitical events could also force changes in political priorities (53%). The invasion of Ukraine has sparked a cost of living crisis in Europe and caused ESG fatigue among voters (46%). Energy security and affordability has triumphed over climate action. Indeed, backsliding is evident in countries like Saudi Arabia and the UK, and is also flagged by the recent election of climate-sceptical leaders in the Netherlands and Argentina.

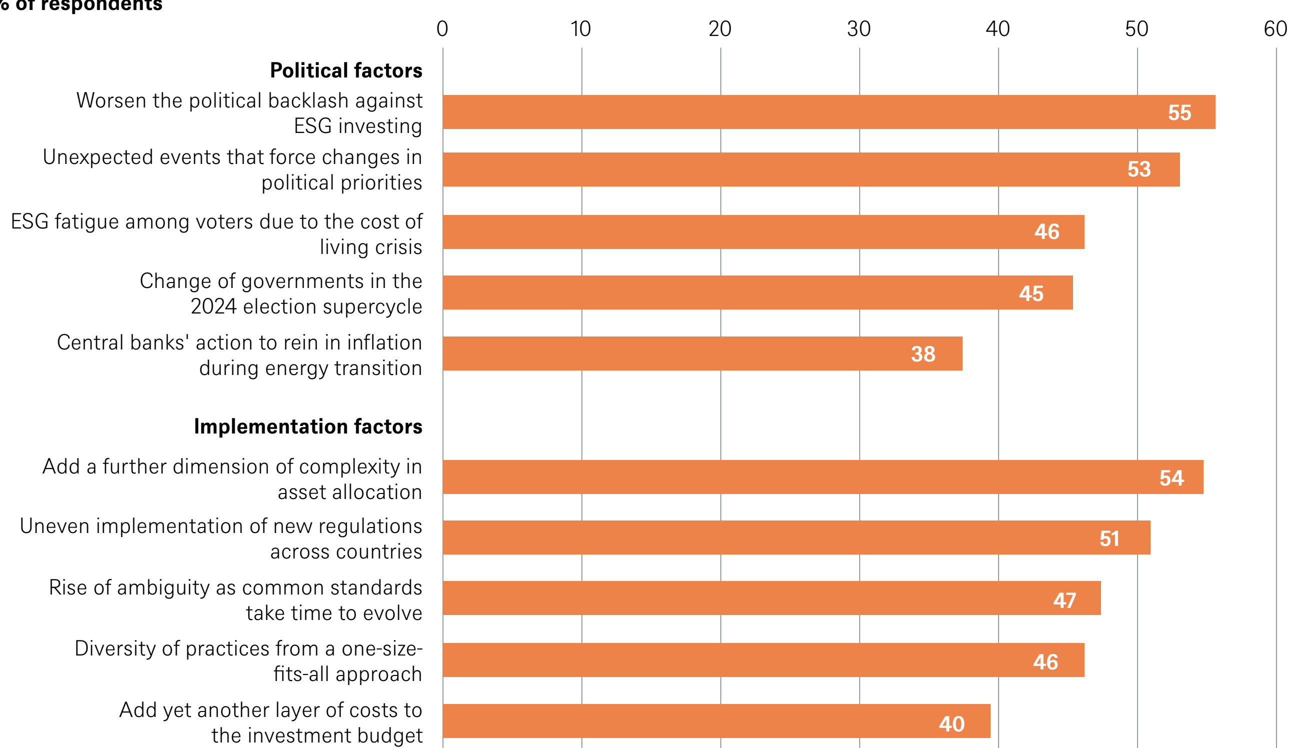
Overlaying these challenges is the prospect of changes of governments in the West due to the 2024 election super cycle, when around half the world's adult population is due to vote, and there is a real prospect of anti-ESG governments coming into power (45%). Far-right parties across Europe have sought to boost their polling and votes by adding resistance to climate change measures to their election manifestos. Another political 'known unknown' is how central banks will react, if concerted climate action proves inflationary, as is widely expected (38%). For example, electric vehicles use six times the amount of minerals used in conventional cars, driving up the price of copper, cobalt and lithium. It takes up to ten years to open up new mines. The faster the transition to green energy, the more expensive it may become in the near term as a result.

Turning to implementation barriers, the uneven ways in which the new measures are to be implemented is likely to cause fragmentation between countries (51%). This will create transitional ambiguity as common standards take time to evolve (47%). The spiderweb of sustainability measures recently introduced in the EU is leading to interpretation complexities, as shown by the 2022-23 mass declassification of Article 8 and 9 SFDR funds in the EU. It showed that regulatory and policy measures will take time to embed as a result of learning-by-doing refinements. This much is clear as the EU has opened extensive consultation on the changes needed to refine the SFDR.

Figure 2.3

Which factors could undermine the impact of recent regulatory and policy measures in the near term?

% of respondents



Source: CREATE-Research Survey 2024

"No matter which party wins in the US November presidential election, the trend to develop clean energy in the US will not change."

An interviewee quote

Another implementation issue is the one-size-fits-all approach implicit in all regulations that fails to catch the diversity of practice across countries (46%). This applies especially to the alphabet soup of standards that are being harmonised to achieve geographic comparability. Critics argue that most of them should be used in tandem, as they all focus on the triple bottom line principle: profit, people and planet. Harmonisation can stifle the innovation and experimentation that could eventually deliver best practice standards.

There are also other constraining factors such as the addition of another layer of costs to the investment budget from regulatory creep (40%), which can also add to complexity in asset allocation (54%).

Overall, these political and implementation barriers will slow the pace at which the regulatory and policy changes of recent years are embedded into the ecosystem of capital markets. Regulators, governments and investors are on an adaptive journey with teething problems en route. The journey is an evolving iterative process.

These political and implementation barriers will slow the pace at which the regulatory and policy changes of recent years are embedded into the ecosystem of capital markets.

Most pension plans are already factoring the new measures into their asset allocation decisions and looking out for signals that markets are, in fact, further adapting to the evolving regulatory and policy environment in earnest. This is in line with the adaptive markets hypothesis, that ascribes market failure and market inefficiency to investor foibles and how these are corrected as new information becomes available in fits and starts, as it has been since the dawn of capital markets. Each barrier could melt away with the passage of time.

Insights

US Pension plans are caught in the political crosshairs

Last year, Congress passed a bill that would block the latest rule from the Department of Labour to allow private sector retirement plans under the Employee Retirement Income Security Act to consider ESG factors in their asset allocation, affecting $12 trillion of assets. President Biden duly vetoed the bill – the first veto of his term.

In response, some 25 Republican states announced a lawsuit against his administration. Some of them have even proposed or adopted state legislation that precludes state pension funds or agencies from doing business with investors that use ESG criteria. Texas was the first to pass the boycott rules in 2021, preventing local entities from doing business with banks that adopted ESG policies, triggering other states to do the same.

On the Democratic side, some 20 states are making demands for the fuller company disclosure of ESG factors and filing lawsuits against energy firms that fail to honour their promises. Indeed California, Maine and Oregon have even enacted thermal coal divestment laws.

These starkly opposite approaches lead to elevated policy uncertainty that makes it harder for us to invest in ESG without increased reputational and financial risk. A change in administration after the 2024 presidential election could lead to the unravelling of the progress made towards promoting ESG investing.

This could have a snowball effect in Europe where the cost of living crisis has already seen some political backsliding on ESG issues.

Only time will tell whether these are temporary blips or formidable barriers.

A US pension plan

3

The impacts of new measures: Where will the benefits be most evident?

"Adverse ESG events are hitting our portfolio companies frequently. Capital markets can no longer afford to ignore them."

An interviewee quote

Overview

This section highlights three issues:
- Which ESG pillars will benefit most from the recent regulatory and policy measures?
- Which asset classes and geographies will benefit most from these measures?
- What investment outcomes are likely to flow as a result?

Key findings

a. ESG pillars

The main points are:
- Natural environment is the most favoured pillar currently and also the one likely to benefit most from the recent measures, according to the survey.
- The social and governance pillars are likely to benefit too, both directly and indirectly, from spill-over benefits from the environmental pillar.
- ESG investing has become more complex as trade-offs have emerged within and between the pillars, requiring judgement calls in the absence of credible data.

b. Asset classes

The main points are:
- Benefits resulting from the measures will vary across asset classes and geographies.
- Public market equities are expected to benefit most, followed by public market bonds and private market alternatives.
- Developed market assets are likely to benefit most, but developing market assets will also enjoy some spill-over benefits because of the extraterritorial nature of some of the new measures. These will require developing market companies to burnish their ESG credentials to avoid import taxes in Europe and the US.

c. Investment outcomes

The main points are:
- Hitherto, ESG risks have been priced into securities valuations somewhat selectively, while funds have been managed using longstanding entrenched rules of fiduciary duty.
- Capital markets are now expected to go through a period of adaptive learning by trial and error, as they price in ESG risks and opportunities, as the new measures deliver change across the wider economy.
- Investors are expected to see better diversification opportunities, improved investment performance, greater liquidity and lower volatility on their ESG assets.

Key message

Capital markets will adapt to the new regulatory and policy measures mostly via trial and error, akin to a J-curve, after experiencing initial hurdles. Markets are always digesting new information and pricing assets accordingly, as part of adaptive learning. Hence, only 27% of our respondents have thus far incorporated ESG factors into their strategic asset allocation.

"Climate is king among environmental considerations, while diversity and inclusion rank highly on the social front."

An interviewee quote

"The economic value produced by biodiversity is worth more than $150 trillion annually, according to the British Safety Council."

An interviewee quote

Recent measures are mainly targeted at climate transition

When asked to single out the most important ESG pillar in their current investment portfolio, environment topped the list (60%), followed by social (21%) and then governance (19%), as shown in Figure 3.1 (left chart).

Outwardly, the ranking reflects four notable areas of progress on climate action made at COP28 in Dubai in 2023.

First, the event reached historic agreement on the operationalisation of the 'loss and damage' fund, which marked the first time a substantive decision was adopted on the first day of the conference. Second, while oil and gas companies have not undertaken to cut carbon production, they have, for the first time, pledged to "transition away from fossil fuels" – something that was obviously necessary, but had been left out of all previous COP agreements. Third, 120 countries pledged to triple the world's renewable energy generation by 2030. Fourth, there was a general commitment to boost energy efficiency, as the quickest and most cost-effective way to cut emissions. These are important steps forward, but not the giant strides the world needs.

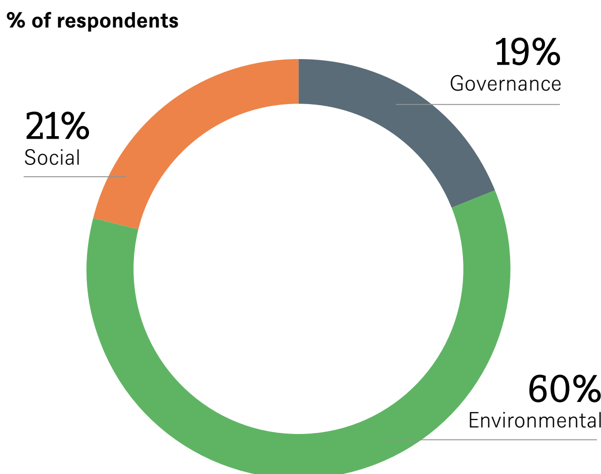
That said, the ranking in Figure 3.1 (left chart) is also nuanced. Alongside progress on the climate front, yet another change has been evident – granularity. In the early phase of ESG investing, pension plans relied on composite data from rating agencies and invested in all three pillars together. But as plans have progressed up the learning curve, trade-offs between and within the individual pillars have emerged (see INSIGHTS on the next page). As a result, plans have been targeting specific areas within each pillar.

In the environmental pillar, current emphasis is on reducing GHG emissions, promoting energy efficiency and boosting green energy. The

Figure 3.1

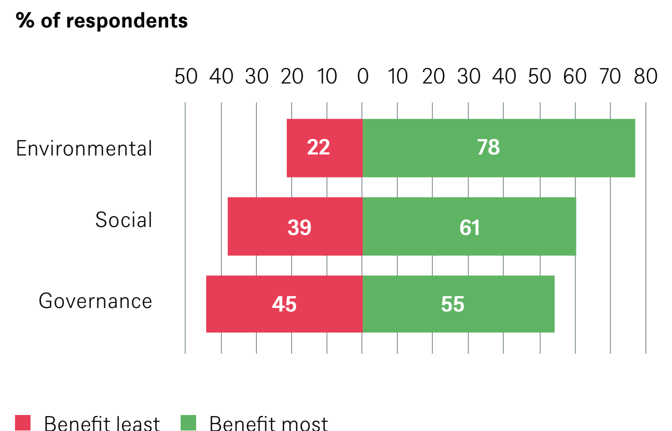
In your ESG investing, which pillar do you currently consider to be the single most important?

% of respondents



Which ESG pillar in your portfolio will benefit most/ least from recent measures?

% of respondents



Source: CREATE-Research Survey 2024

"The Inflation Reduction Act in the US offers tax incentives to clean energy employers who pay a certain level of wages."

An interviewee quote

As plans have progressed up the learning curve, trade-offs between and within the individual pillars have emerged.

International Energy Agency estimates that most of the cleantech needed to achieve the world's net zero is already market ready. The war in Ukraine has spurred a clean energy arms race. Latterly, biodiversity loss has also been attracting growing attention, after the Kunming-Montreal Global Biodiversity Framework was adopted at COP15 in 2022. Global warming and biodiversity loss feed off each other. Global warming has altered marine, terrestrial and freshwater ecosystems worldwide. It has caused the loss of local species, increased the incidence of disease, and driven the mass mortality of plants and animals, resulting in the first recent climate-driven extinctions. Increased biodiversity, in contrast, can improve the ecosystem while reducing global warming. Climate action needs a vibrant natural ecosystem.

In the social pillar, the emphasis is on promoting workforce diversity and inclusion, eradicating abuses in supply chains and promoting human rights.

In the governance pillar, the emphasis is on linking corporate executive incentives to ESG outcomes, having diversity in board composition and eradicating bribery and corruption.

Overall, ESG investing is now about the selectivity of specific themes, rather than a blanket approach.

Overall, ESG investing is now about the selectivity of specific themes, rather than a blanket approach.

Insights

Trade-offs inherent in ESG investing require judgement calls

In principle, ESG investing sounds simple: just invest in companies that are rated as leaders or improvers. In practice, the composite ratings now in use conceal more than they reveal. They cover too many factors at once, leading to a loss of clarity and strategic attention to what any of it actually means. For a large investor like us, this seems like three random letters thrown together without regard for their visible trade-offs.

We have invested a lot in the 'ESG darlings', like the Danish renewable energy giant Ørsted. Even with an overfull order book, its share prices have had a rough 2023, as the oil and gas sector has been buoyed by skyrocketing fossil fuel prices following Russia's invasion of Ukraine. Clearly, ESG investing is not immune from collateral damage or periodic setbacks.

There are other trade-offs inherent in ESG pillars. An example of trade-offs between the pillars can happen if climate action is successful. Some 60-80 percent of the known fossil fuel reserves of listed companies today could become stranded assets from the premature write down of their monetary value, according to the Carbon Tracker Initiative. This could inflict severe socioeconomic hardship on local communities.

Another significant trade-off within an ESG pillar centres on social media giants. With their emphasis on talent, they score highly on the social factor and thus attract pension capital. But we worry about uncensored material that harms the political process in democracies and children's well-being in general. They have huge unregulated influence without any regulatory sanctions. They require important judgement calls on our part.

A French pension plan

"Trade-offs between and within ESG pillars create an extra layer of complexity in asset allocation. They are hard to model."

An interviewee quote

Turning to how the recent regulatory and policy measures covered in Section 2 are likely to benefit individual ESG pillars in our respondents' portfolios. Once again, environment stands out (78%), followed by social (61%) and governance (55%), as shown in Figure 3.1 (right chart). The reason environment stands out is obvious: the central thrust of most of the key regulatory and policy measures has been directed at climate adaptation and mitigation. But many of these measures also have spin-off benefits for the other two pillars. For example, the Inflation Reduction Act in the US aims to provide adaptation finance to support local communities badly affected by the transition to green energy. Similarly, the EU's 'Fit for 55' programme expressly aims to cut GHG emissions while supporting the most vulnerable citizens and sectors by creating a new Social Climate Fund. The EU's Carbon Border Adjustment Mechanism also aims to protect EU jobs by raising barriers against regulatory arbitrage.

On the governance side, too, climate measures are likely to create lateral benefits by overtly promoting stewardship that requires strong corporate oversight.

The upshot is that regulatory and policy measures are buttressed by the progress made by COP. Together, they are creating momentum on a wider ESG front, despite the challenges highlighted in Section 2.

All broad asset classes are expected to benefit from recent measures

According to the survey respondents, the benefits of bonds in public markets are likely to be felt more widely over the next two years (48%) and the next five years (62%), as shown in Figure 3.2. The corresponding figures for public market equities are 41% and 61% and for alternatives in private markets are 36% and 58%. Three reasons explain the differential pattern.

First, pension plans are increasingly recognising the potential of three types of bonds to drive the biggest and best environmental and social change in the region where the proceeds are invested. One type is the 'use of proceeds' instrument, guided by gold standard ICMA principles that raise capital for projects with positive environmental or social impact.

The second type comprises sustainability-linked bonds. They are linked to specific pre-agreed targets like reducing GHG emissions or enhancing workforce diversity and inclusion. They permit engagement with issuers at the pre- and post-issuance stages to attain responsible capital allocation.

The third type comprises transition bonds. They are not 'green' per se but aim to reduce carbon emissions in hard-to-abate sectors like cement and steel.

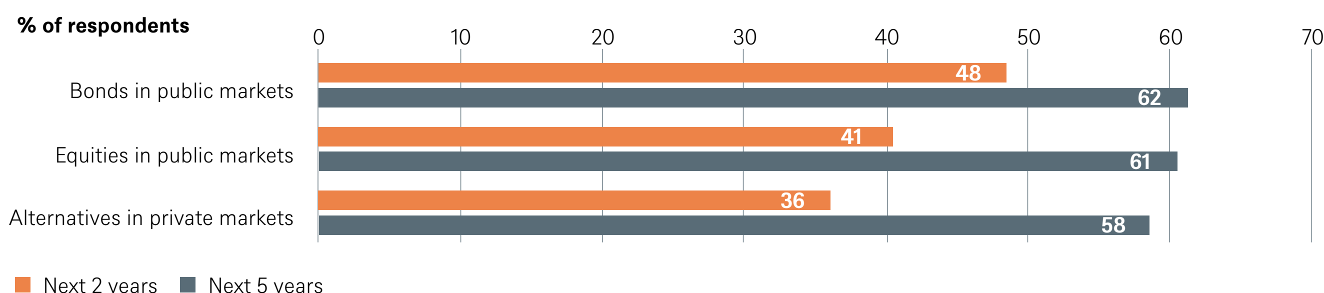
Many pension plans are reaching the stage when replacing a part of their sovereign bond portfolio with these three types of bonds is a logical step. The distance-to-default, a market-based measure of corporate default risk, is believed to be negatively associated with a company's carbon intensity. Those with a large carbon footprint are now perceived

Pension plans are increasingly recognising the potential of three types of bonds to drive the biggest and best environmental and social change.

"We see a better alignment between ESG goals and the new generation of bonds based on the widely recognised ICMA principles."

An interviewee quote

Figure 3.2
Which asset classes will benefit most from the new measures over the next two/five years?



Source: CREATE-Research Survey 2024

by the market as being more likely to default, all other things being equal. Carbon intensity has an effect on corporate creditworthiness, according to our interviews.

The second reason behind the differential pattern is that the benefits of recent measures for public market equities will be somewhat curtailed by two of their inherent features – high volatility and years of overvaluation due to central bank liquidity – that have made it harder for current prices to reflect their fundamentals. In the 2022 bear market, many companies in the renewable energy sector were hit by factors that had little to do with ESG.

The third reason centres on alternative investments. They face a different issue. Their portfolio allocations to ESG funds is typically around less than 8% currently. But it is set to rise when new blended finance projects envisaged under new policy measures – offering concessionary finance – are likely to take off and benefit the three key alternative asset classes: infrastructure, private equity and real estate. The projects involve green infrastructure, new electrification and green buildings. Such projects encourage private–public partnership in social or environmental initiatives that would otherwise struggle to find investors.

Turning now to geographical variability, one message stands out from our post-survey interviews: the new measures are expected to benefit developed market assets more than developing market assets – at least initially.The reason is that companies in developed markets embraced ESG investing ahead of their developing market peers due to pressures from regulators and society.

In contrast, most developing economies have long been preoccupied with economic growth to improve living standards. Indeed, industries at the core of this economic catch-up – cement, steel, chemicals – are also super GHG emitters. With break-neck economic growth over the past 30 years, China is now the biggest GHG emitter.

Worse still, for decades, developed economies have offshored some of their heavily polluting manufacturing activities to their developing market peers.

But new regulations in the West are likely to redress this imbalance via extraterritoriality. They will require multinational companies domiciled in developing economies to up their ESG game, as the EU starts to impose higher carbon taxes on its imports under the Carbon Border Adjustment Mechanism. This is in the belief that climate risks are more immediate and no longer a slow burn issue (see INSIGHTS on the next page).

Additionally, along with Australia, Canada and the US, the EU is also imposing tougher rules on imports tied to child labour, which is mainly prevalent in developing economies.

> The new measures are expected to benefit developed market assets more than developing market assets – at least initially.

“The largest US property insurer has ceased to offer new property and casualty insurance in California, due to catastrophe exposure.”

An interviewee quote

Insights

Tectonic shifts are rife with financial risk

Our comparison of corporate ESG leaders and laggards showed that the former were more competitive and profitable. They were also strong on risk management and compliance in their supply chain. Thus, they were less vulnerable to market shocks in 2022-23. But we also found that ESG is not a one-way ticket to good returns. The state of capital markets – hit by inflation and the Ukraine war – remains a major contributory factor. But we also know for sure that ESG risks can whipsaw our portfolio.

This was evident from three seminal events: huge clean-up costs incurred by BP after the Deepwater Horizon disaster in the Gulf of Mexico in 2010; steep punitive fines and penalties imposed on Volkswagen for emission cheating in the US in 2015; and Vale after the Brumadinho dam collapse in Brazil in 2019, which cost $7 billion in compensation to the victims.

Clearly, ESG risks are no longer slow-burn issues of a long-term nature. They are getting more acute and more frequent with continuing global warming and declining biodiversity.

Hence, we expect that, in response to a raft of new regulation in the past four years, capital markets will take notice of and factor in risks and opportunities. Much will depend upon how quickly the new regulatory and policy measures create impetus for action in our portfolio companies. For now, the best way to get good returns is via stewardship and proxy voting – both essentially forward looking. With credible resources, they can materially improve the quality of our alpha and beta ESG assets.

A Dutch pension plan

New measures are expected to enhance ESG outcomes

According to a March 2024 report from MSCI, ESG Ratings in Global Equity Markets, global portfolios with higher ESG ratings earned a better annual compound return compared with the portfolios of worse-rated companies over the period 2013-21, for a majority of companies in 10 out of the 12 key economies. In the US, for example, leading companies notched up a 50% premium in terms of returns.

It is hard to assess how far these findings were helped by the background long-running bull market. That it helped is not in doubt. Nor is there any doubt that ESG risks were being priced into asset values at least selectively, implying a degree of market efficiency.

This was at a time when the funds were managed using longstanding, entrenched rules of risk/return, prudency, fiduciary duty and other elements of financial industry culture that have supported the very industries that led us to the global climate crisis in the first place.

"Emerging economies have been preoccupied with economic growth to raise living standards instead of worrying about ESG impacts."

An interviewee quote

ESG investing's opportunity set will expand in a number of positive ways.

Under the new regulatory and policy measures described in Section 2, capital markets are expected to go through a period of adaptive learning by trial and error as they price in ESG risks and opportunities, and as the measures deliver changes for economies and wider society (see INSIGHTS on page 38).

As a result, ESG investing's opportunity set will expand in a number of positive ways (Figure 3.3, left chart).

To start with, respondents expect more opportunities for diversification due to the uneven pace of implementation by different countries (51%). This will create a variety of openings to diversify by country.

Furthermore, respondents expect the resulting arbitrage potential will serve to enhance investment returns (52%), although a significant minority (22%) believe that the effect could also be negative. This is especially likely if ESG risks are priced in too quickly, causing overcrowding, which could dilute the return and limit the scope for generating market-beating returns.

Finally, markets in which risks and opportunities are better priced in are likely to offer better liquidity (39%) and lower volatility (36%).

However, there is also ample recognition that the path to an expanded opportunity set will be neither linear nor rapid. Market returns will continue to be influenced by macro factors such as interest rates, inflation, GDP and geopolitical events. These could overwhelm idiosyncratic risks like ESG that pertain to individual companies. This much has been evident from the latest headlong fall in the stock price of the ESG 'darlings' – renewable energy companies. They have been unduly hit by rising interest rates, which increased the cost of capital, and compounded by the long-term nature of supply contracts that did not anticipate the recent inflationary spike.

Such vulnerabilities go a long way towards explaining the currently low proportion of our survey respondents who have incorporated ESG factors into top-down strategic asset allocation. So far, only 27% have done so, putting them on a par with traditional macro risk factors such as GDP, inflation and interest rates (Figure 3.3, right chart). There are two reasons behind the slow progress.

First, as adverse weather events are becoming more frequent and ferocious, global warming is reaching a tipping point beyond which the scale and timelines are hard to predict in any models. Or as Mark Carney, the former governor of the Bank of England argued, by the time climate change becomes a defining issue for investors, it will be too late to reverse it and even harder to model it.

Second, a lot more evidence is needed than is

As markets pay ever more attention to ESG factors in response to new regulatory and policy measures, an increasing number of pension plans expect to incorporate ESG into their strategic asset allocation with its own policy benchmark.

"Private market assets are ideally suited for blended finance, as promoted by governments and the multilateral institutions."

An interviewee quote

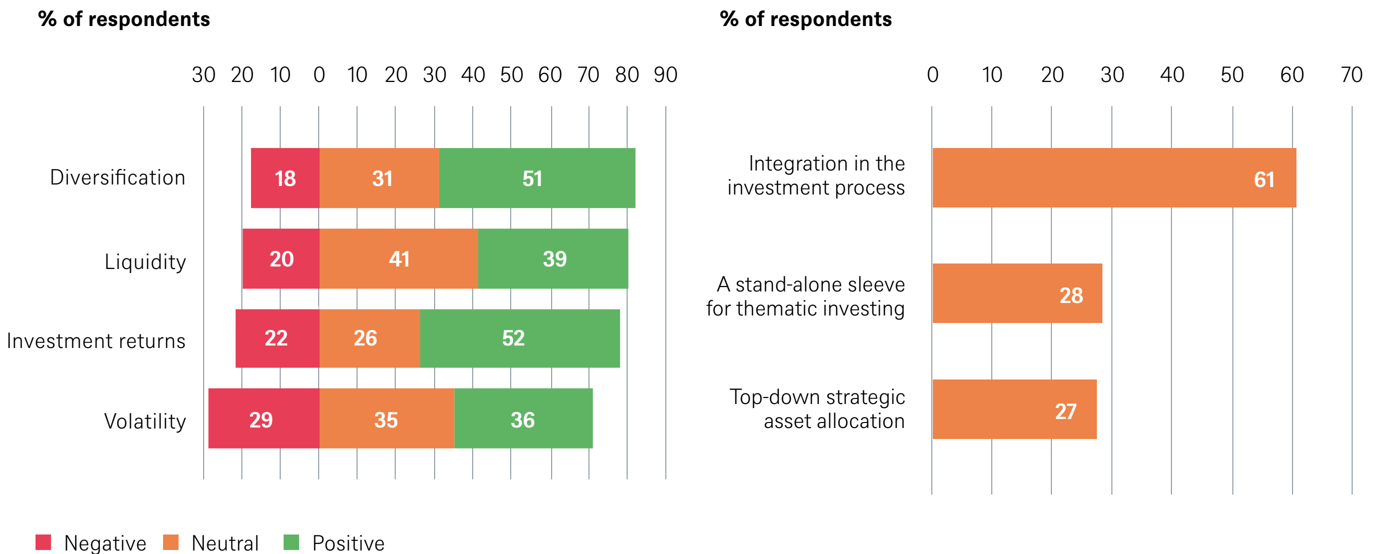
> "Currently, capital markets price in ESG risks on a selective basis. This will expand as the new measures begin to bite in earnest."

An interviewee quote

currently available to show that ESG is indeed a compensated risk factor. The evidence now available shows that, in fact, this is the case mainly in Europe but less so in North America and Asia Pacific.

As markets pay ever more attention to ESG factors in response to new regulatory and policy measures, an increasing number of pension plans expect to incorporate ESG into their strategic asset allocation with its own policy benchmark. That way, ESG investing is no longer constrained by the traditional cap-weighted benchmarking framework. In the meantime, two other approaches are likely to prevail: ESG integration via bottom-up security selection (61%), and thematic investing that is deployed within the core–satellite model as a separate sleeve (28%). The latter seeks to pursue multiple themes, with periodic tactical switches to capitalise on 'green' alpha.

Figure 3.3
What impact will regulatory and policy measures have on your pension plan's ESG portfolio over the next 3-5 years?



Source: CREATE-Research Survey 2024

> "Like humans, markets have an adaptive mechanism as their ecosystems respond to external interventions."

An interviewee quote

"Scientists have warned that global warming has already entered new territory by exceeding 1.5°C in 2023, according to Copernicus, the EU's Earth Observation Programme."

An interviewee quote

Insights

Capital markets will adapt to regulatory and policy measures mostly via trial and error

Years of investing have taught us that capital markets are a product of human evolution, always adapting to changing surroundings. Decisions are reached not analytically, but via trial and error, which enables one to develop simple rules of thumb that evolve into new heuristics over time, displacing the old ones bit by bit.

In that respect, the 2015 Paris Agreement was a watershed. It fostered the recognition that pension plan members not only need a financially comfortable retirement but also a habitable planet and a stable society to live on and in.

For too long, ESG issues have been treated as 'non-financial'. It is now time to ditch this label from the corporate lexicon and treat ESG issues with the same rigour and diligence as financial reporting.

The Covid pandemic shook our assumptions about the way we live and exposed the financial materiality of all ESG issues.

How companies treat their employees is now a key proxy on their potential to respond to other shocks.

This is now duly reflected in a raft of new rules and policies over the past four years. As they take effect, investors will develop a new set of heuristics that are suited to the new reality. Prior to the correction in 2022, the longest-running bull market in history served to conceal market failure and market inefficiency in ESG investing.

Since then, the new measures mark a turning point. Singly, they may not seem catalytic enough. Together, they will be quite consequential in hindsight.

A Canadian pension plan

"It's just a matter of time before the recent measures elevate ESG factors into strategic asset allocation."

An interviewee quote

Return to contents page

The advance of passives in ESG investing: What is the current state of progress?

"Markets tend to reward the risks inherent in secular themes like ESG over longer periods."

An interviewee quote

Overview

Aims

This section addresses three issues:
– What are the current allocations to ESG themes in active and passive pension portfolios?
– Why will actives and passives continue to complement one another in pension portfolios?
– How are the new generation of ESG indices coming on stream?

Key findings

a. Current allocations

The main points are:
– 43% of our respondents' ESG assets account for over 20% of their active portfolio; the corresponding figure for the passive portfolio is 28%.
– These shares have been driven by the search for early mover advantage, as fat-tailed risks are now more frequent and ferocious.
– These shares are likely to rise in the wake of the new regulatory and policy measures.

b. The active–passive dynamic

The main points are:
– Both these styles are seen as more complementary than competitive; both have strengths as well as limitations.
– Actives are targeted at illiquid markets where price anomalies are rife; passives are targeted at liquid markets that are highly efficient.
– Instead of excluding ESG laggards from the ESG indices, the emphasis now is on minimal exclusion, with an overemphasis on ESG leaders and improvers.

c. Newer generation of indices

The main points are:
– Newer forms of indices with higher tracking error mark a big shift from traditional cap-weighted indices.
– They are likely to grow in importance as a result of new regulatory and policy measures that improve the price discovery of ESG risks.
– The rise has underscored the need to have reliable corporate data on these risks and their attendant opportunities.

Key message

ESG investing is adopting different approaches and styles as it advances into pension portfolios. The main thrust of innovation is driven by the arrival of indices with high tracking errors to capture ESG upsides. They will receive fresh impetus from the new measures in recent years.

"Thanks to the new measures, ESG is undergoing a makeover. It will emerge more client centric and robust."

An interviewee quote

Early mover advantage has been a key driver of ESG

At this stage in its evolution, our survey respondents have made varied allocations to ESG investing in their active as well as their passive portfolios (Figure 4.1). Notably, in 43% of active portfolios, the current share of ESG allocations is over 20%. The respective figure for passive portfolios is 28%.

The proportions for the active portfolios are higher because ESG first took off in the active space. Progress in the passive space came later when their managers delivered a range of indices, backed by stewardship and active engagement with companies in their indices. They are catching up fast. This is clear from Figure 1.6 in Section 1: ESG-based passive exposures are likely to have more broadly based growth than their active counterparts.

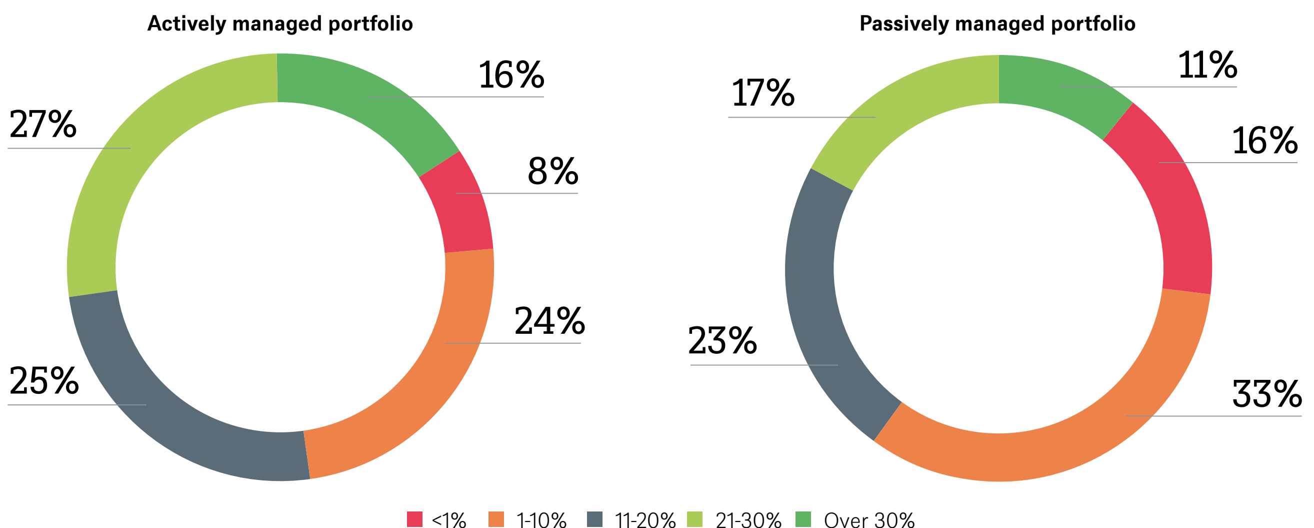
In this decade, both active and passive portfolios have seen a headlong incursion into the ESG space, even though capital markets have been pricing in ESG risks on a selective basis. The main reason is the growing belief in the pension world that one of the biggest weaknesses of today's investing is that it is overly influenced by Modern Portfolio Theory, which ignores negative externalities such as environmental pollution, biodiversity loss, supply chain abuses and governance lapses: all of which have the potential to savage the company's bottom line. Until the recent past, corporates had privatised gains and socialised costs.

> The failure of Pacific Gas & Electric Company in 2019 was a defining moment: the first climate change bankruptcy in history.

Figure 4.1

What is the current approximate share of all ESG investments in your pension plan's two portfolios?

% of respondents



Source: CREATE-Research Survey 2024

"We are hard-nosed investors looking for investment opportunities that will deliver good financial as well as societal outcomes."

An interviewee quote

The failure of Pacific Gas & Electric Company in 2019 was a defining moment: the first climate change bankruptcy in history. It was sparked by increasingly dry conditions recorded in California the preceding year. The company had recognised the risks of severe wildfires, yet had failed to address them. It showed how valuation mirages can often conceal severe risks that are hiding in plain sight. Only risks that are plainly visible, especially visceral ones, tend to attract attention.

This seminal episode reinforced the belief that, more than ever, long-term economic value creation now also rests on natural, social and human capital – as shown all too vividly by Covid-19.

In this age of tectonic shifts, investing by merely looking in the rear-view mirror is a recipe for failure.

The new measures on disclosure of ESG risks – discussed in Section 2 – will go a long way towards exposing such risks and subjecting companies to expensive litigation and reputational damage if they choose to ignore them.

Moving early to anticipate existential threats to the current business models could turn them into opportunities. In this age of tectonic shifts, investing by merely looking in the rear-view mirror is a recipe for failure. ESG investing forces investors to look at all the changes around them. The world does not stand still.

This is duly reflected in the mix of five benefits that our survey respondents are variously targeting in their ESG investments. Some focus on returns, some on risks.

Far and away, the most widely sought benefit is good risk-adjusted long-term returns. Some of the respondents involved in impact investing are also targeting a treble bottom line – doing well financially and doing good environmentally and socially. 'Doing well by doing good' is the new mantra.

On the risk side, they target a more defensive portfolio that minimises fat-tail exposures. Some also target lower portfolio volatility and some better diversification. As both Covid and the Ukraine war have shown, low probability–high impact events can come like bolts from the blue and whipsaw portfolios at a time when many of the defined benefit pension plans in our survey are advancing rapidly into their run-off phases with aging demographics. They are especially vulnerable to the sequence of returns risk: the time it takes for a portfolio to recover after big market reversals just when pension liabilities are maturing fast.

This applies especially to the current negative fat-tail risks that have no historical precedents. Thus, while markets are slow to factor them, they also carry early-mover advantage. That the markets will, before long, be fully pricing in risks like climate change and societal upheavals is not in doubt. But progress will not be linear, as new measures face unexpected headwinds (see INSIGHTS).

In the meantime, bandwagon premium is expected to come ahead of a triple bottom line.

"Passives will always remain attractive for those who want low-cost market beta."

An interviewee quote

Insights

Rigid adherence to old style 'fiduciary duty' is proving counterproductive

Implemented in 2021, regulations under a major initiative titled 'Your Future, Your Super (YFYS)' shows how good intentions in one area can produce adverse unintended outcomes in the ESG area for Australian superannuation funds.

These regulations aim to enhance member engagement, reduce fees, improve investment returns and hold trustees to account for their decisions. Products from superannuation funds are now subject to an annual performance test with clear consequences that aim to tackle poor returns and high fees.

The performance measure has two elements: the extent to which the actual return deviates from the benchmark return; and the extent to which actual fees and expenses deviate from their benchmark levels. Any product failing on these two criteria for two consecutive years are closed to new members until they pass a future fitness test. The approach may make sense, given that supers have faced challenges around returns and fees in the past.

But, for members interested in ESG investing, it poses a question. The benchmark return is a passive investment portfolio of indices tailored to the product's chosen strategic asset allocation. As an unintended consequence, however, the measure encourages benchmark hugging to the point where members missed juicy returns from active investing in 2023. Worse still, it disfavours ESG investing. Styles such as ESG integration and negative screening deviate from benchmarks, as they tend to have a higher tracking error against broad market indices. Adopting alternative benchmarks with higher tracking error is currently hard, as there is no consensus on the definition of ESG.

An Australian superannuation fund

Passives are likely to coexist with actives, not displace them

When key central banks embarked on quantitative easing in 2009, they effectively set a floor under asset prices and dampened their volatility, bringing forward future returns. Active managers struggled, as prices became unmoored from their fair value; while passives advanced from the periphery of pension portfolios to the core.

Critics held that once central bank liquidity is withdrawn, the pendulum will swing towards actives. That has yet to happen after central banks embarked on aggressive rate hikes in 2021-22. In the resulting bear market, the majority of active managers failed to beat the markets, according to SPIVA | S&P Dow Jones indices.

For pension investors, passives have become a foundational trend by advancing into core portfolios.

Yet, they are unlikely to displace actives (Figure 4.2). Respondents state that the two will coexist in a diversified portfolio (68%). Allocations to both of them are likely to rise over the next three years, as seen in Figure 1.5 in Section 1. The regulatory and policy measures of recent years are likely to favour passives, according to the respondents, due to their lower costs and recent superior track record. Actives work when there is greater performance dispersion between individual stocks in an index that lowers their correlation. But reality is a tad different (see INSIGHTS on page 45).

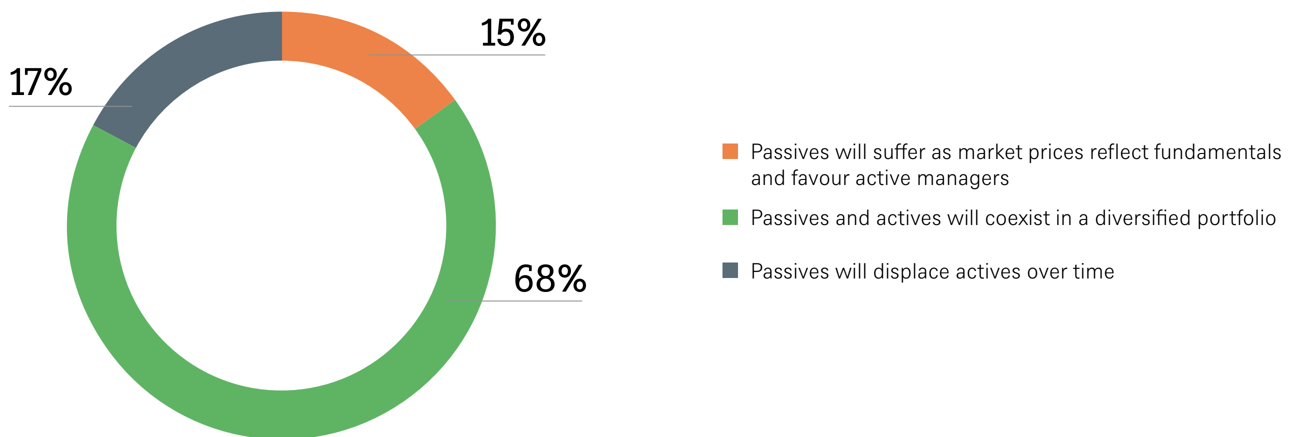
"Active managers need to craft a new narrative on what they stand for and what they can deliver to remain relevant."

An interviewee quote

Figure 4.2

Looking ahead to the next three years, which of the following statements summarises your views about the impact of the recent measures on passive vehicles focused on ESG?

% of respondents



Source: CREATE-Research Survey 2024

Yet, both of them are now seen as complementary. Passives are at the core of a portfolio that covers liquid and efficient markets, where price anomalies are few and far between and where too many active managers are fishing in a limited pool of alpha. Actives, in turn, are targeted at markets that are illiquid and inefficient where such anomalies are rife and reward managerial skills.

In any event, the active–passive choice is not binary. Passives have proven strengths, as seen in the last subsection, but they also have certain limitations. For a start, passives are seen as relying on yesterday's winners, which overinflates the prices of their constituent firms. The most valuable firms continue to remain so, regardless of their future prospects. Passives are also seen as reducing diversification benefits as their components move in lockstep in terms of price movements and trading volumes. Finally, passives are highly scalable. Their continuous rise is now resulting in the growing concentration of voting power among mega indexers, who can potentially override the wishes of other investors.

> The regulatory and policy measures of recent years are likely to favour passives, mostly because of their lower costs and recent superior track record.

In any event, the choice between actives and passives is not black and white. This much is clear from the rise of granularity in ESG investing. As innovation is moving to ever-narrower indices, this ultimately results in active decision making that mimics active stock picking. This applies especially to those indices targeting a triple bottom line.

As the forward-looking double materiality provisions in the CSRD in the EU become embedded, impact investing will get a welcome boost – especially in Europe – and passive ESG investing will increasingly become active through such active decision-making.

Thus, pension plans are already operating along a spectrum of investing with low-cost/rules-based investing at one end and high-cost/discretionary investing at the other. The aim is to achieve an optimal mix of market risk and idiosyncratic risk along the continuum.

"We use active funds in inefficient markets."

An interviewee quote

The drive towards granularity is also impacting how indices are now constructed. Before then, the exclusion of ESG laggards from the index tended to deviate the portfolio's profile from the parent benchmark's risk–return and market profile. It helped pension plans to remove exposure to specific securities and sectors, while foregoing the opportunity to engage with the laggards.

Lately, as interest in the decarbonisation of the portfolio has intensified, the trend is towards minimal exclusion, combined with the reallocation of capital from companies with low ESG scores to those with high or improving scores; thus reducing carbon emission intensity relative to a parent benchmark.

Such pragmatism also facilitates engagements with ESG laggards in the belief that those who are part of the problem can also be part of the solution.

The drive towards granularity is also impacting how indices are now constructed.

Insights

New measures are unlikely to alter the active–passive dynamic

Critics had long contended that the true test of passives is best judged not when markets are rising, but by their resilience when the inevitable correction comes. Hence, the 2022 bear market was meant to be a moment of reckoning. In the event, at least in the key markets in the West, passives have continued to attract fresh net in-flows, while the majority of active funds failed to outperform in the down market.

For us, the lower costs of passives are a big plus, if markets go into a low real return era, with interest rates remaining higher for longer. Another advantage of passives is their role as effective liquidity management, hedging and portfolio rebalancing tools that meet cash flow needs while permitting tactical calls in times of market dislocation. Finally, we use passives for international diversification to capitalise on the different economic outlooks of countries across the globe that lower correlations between capital markets.

As and when new ESG regulations take effect, the cost of investing may well rise and enhance the appeal of passive investing. For us, compounded low cost has been one of the reasons behind our portfolio's outperformance over the past ten years. We also believe that markets are likely to remain distorted by central banks and geopolitical turbulence for the foreseeable future.

The world is in the midst of a polycrisis, where many intractable events are arising at the same time and, together, can have a big effect. Markets will remain more unpredictable than usual, and actives may find it hard to beat them. Beta assets have been the main source of wealth creation in our portfolio in the past and they will remain so in the near future.

A Finnish pension plan

"With rising granularity in the ESG space, passives will increasingly become more active with a high tracking error."

An interviewee quote

"Regulations that promote ESG will raise the cost of investing and favour passive funds."

An interviewee quote

Passives are driving innovation in indices

From their early incarnation as cap-weighted index trackers, passives have evolved into being more active along two distinct paths in pension portfolios.

The first path has seen the rise of factor investing: a third way of investing that blurs old demarcations between actives and passives, with clear overlaps at each end. As a rules-based style, it has appeared under the guise of smart beta by using fundamentally weighted indices.

In smart beta strategies, asset classes can be broken down into factors that explain their risks, their returns and their correlations. The factors in question are value, size, momentum, low variance, market, term and credit. In each case, the index selects for or is overtly tilted towards certain factors in order to realise their risk premia.

Passives have evolved into being more active along two distinct paths in pension portfolios.

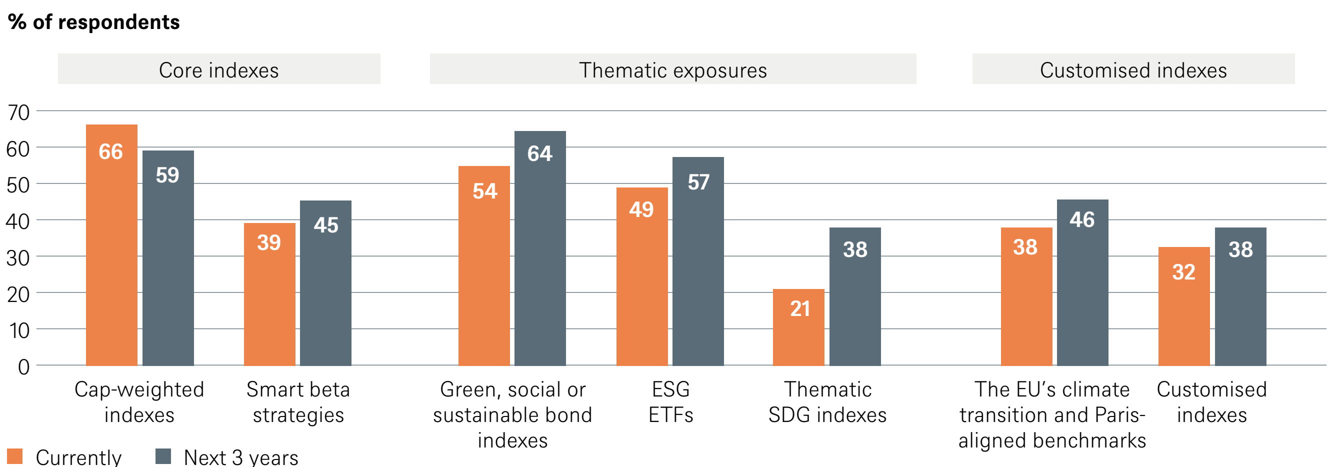
Smart beta strategies gained traction in the last decade as the traditional asset class diversification failed when it was needed most in the 2008 global financial crisis. Although systematic in nature, smart beta requires judgement calls to decide which factors to choose and when to rebalance them. Being 'smart' means choosing the right factors and their weights during periodic rebalancing to achieve low-cost alpha at beta risk.

The second evolutionary path has emerged with the rise of passive investing in the ESG space. It has

Figure 4.3

What are the main vehicles used in ESG investments currently in the passive space and which will be used over the next three years as a result of the new measures?

% of respondents



Source: CREATE-Research Survey 2024

"Passives now account for around 25% of total global assets. But their share of daily trading is double that amount."

An interviewee quote

"The rise of smart beta strategies shows how passives are morphing into a hybrid model with some active elements."

An interviewee quote

led to the adoption of a more active tracking-error controlled approach towards chosen companies' progress towards meeting their ESG goals. This has led to a proliferation of indices targeting realistic real-world ESG outcomes in three groups (Figure 4.3).

The core group will likely see traditional cap-weighted indices lose pole position as part of the shift to newer indices: 66% of our respondents rely on them now and that is likely to fall to 59% over the next three years. They will remain a significant vehicle for those pension plans who are seeking a free option on sustainability that gives an upside as markets start to price in ESG risks and minimise the downside risk of capital loss if they don't. On the other hand, another item in the core group – smart beta strategies – is likely to gain traction: up from 39% currently to 45%.

The second group covers thematic green, social and sustainability-linked bond indexes (as described on page 14) that are likely to see a further advance: from 54% currently to 64% in the next three years. As we saw in Section 3, as pension plans advance into their run-off phase, these bonds are gaining traction in their portfolios. In this group, ESG thematic ETFs are likely to see a further advance too: from 49% to 57%. They are favoured by pension plans, with limited governance budgets and skill sets.

In the third group, there are two distinct sets of customised indices. One set covers the EU's framework for Climate Transition and Paris-aligned Benchmarks: up from 38% currently to 46% in the next three years. EU regulation now requires that, to achieve the net zero carbon emissions target by 2050, a new benchmark must exhibit a 50% reduction in carbon emissions to qualify for the Paris-aligned Benchmark label, and a 30% reduction to qualify for the Climate Transition Benchmark label, among other requirements.

Another set covers exposures that are tailored to client choices on ESG themes and especially support proxy voting: up from 32% now to 38% in the next three years. However, alongside the rise of these indices has come the growing concern that they typically rely on backward-looking data. This penalises companies currently making progress on their ESG journey (see INSIGHTS). Thus, they are not able to track their parent benchmark closely enough to manage risk properly.

In response, pension plans now overtly focus on businesses that have concrete plans to improve their ESG outcomes over a definable period. They also place heavy emphasis on stewardship and proxy voting track record when choosing their index manager, as shown in the next section.

Alongside the rise of these indices has come the growing concern that they typically rely on backward-looking data.

"To capture the ESG upside, the newer generation of indices mark a departure from the traditional cap-weighted indices."

An interviewee quote

"The EU's two climate benchmarks are a credible start towards creating meaningful indices. They will be refined over time."

An interviewee quote

Insights

The role of ESG data providers is set to change

The returns on our ESG investments suffered in 2022-23, after doing well for the previous 10 years. Among others, it exposed the prickly issue of the heavy reliance of ESG data on judgement calls by their providers, while company filings are limited and self-serving.

For example, the electric car maker Tesla is excluded from the S&P 500 ESG Index because of governance issues, whereas ExxonMobil, one of the world's largest polluters, is not. There remains a big dispersion of metrics and methods used by data providers such that capital markets find it hard to price companies on their ESG scores and link executive remuneration to it. For their part, data providers have to make judgement calls on a mix of limited disclosures from companies, multiple metrics and complex scoring methodologies. Different providers give different ratings to the same company. The upward bias in their recent ESG ratings has been a matter of real concern.

Hence, these providers have come under regulatory scrutiny in the EU, India, the UK and the US. From 2025, the EU ratings providers will have to be more transparent, reliable and rigorous about their methods. The aim is to ensure that money goes towards best-in-class ESG companies.

The SEC in the US is now considering whether index providers should be reclassified as 'investment advisers' and brought under the remit of the Investment Company Act 1940. Thus far, the Act has regulated the index product but not its index provider.

Regulatory concerns have come with an explosion of increasingly influential indices in the ESG space in the past five years. Unlike their formulaic-based cap-weighted peers, the new indices give much more discretion to their providers in their design and involve value judgements in their construction.

Their decision to include a particular security in an index has a direct bearing on the user's decision to buy or sell that security. They wield vast influence over the direction of the trillions of dollars needed for the green transition. They are increasingly becoming influential capital allocators in the world. It is time the index providers are mandated to act as a fiduciary.

A Belgian pension plan

"We are not sure how credible the newer indices are without major improvements in their underlying data."

An interviewee quote

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5

A rubric for progress: What are asset managers expected to do?

"Our manager selection process is now more evidence-based than ever. 'Trust but verify' is our guiding principle."

An interviewee quote

Overview

As ESG investing hit a turbulent phase in 2022-23, the spotlight turned on the role of asset managers in delivering targeted outcomes. This is duly reflected in the breadth and depth of criteria now being used by pension plans when selecting their external managers for ESG mandates. Hence, this section considers two issues:
- What are the key criteria now being used in selecting managers consistent with the recent new shift from quantity to quality in ESG investing?
- Which core managerial attributes have come under scrutiny, as some of the largest asset managers in the US now appear to be backsliding on ESG issues?

Key findings

a. Manager selection criteria

These are currently defined by certain attributes that fall into two clusters: one client centric and one business centric.

Within each of them, some focus on managers' track records and some on proxy indicators that ascertain whether the track record has a high probability of being sustained in future.

In the client-centric cluster, the desired track record centres on:
- stewardship and proxy voting
- clients' ESG goals
- a thought leadership brand
- political sensitivity in conveying ESG messaging in a balanced way
- a value-for-money fee structure.

In turn, these attributes need to be underpinned by capabilities that deliver:
- customised ESG strategies
- customised reporting
- a variety of ESG investment options and advice on their use
- access to the client's choice of data vendor.

The business-centric cluster that features in manager selection centres on the track record of:
- insights into how new regulations and public policies affect capital markets and the ESG value chain
- evidence on how core ESG values are embedded in the fabric of the manager's corporate culture.

These attributes need to be underpinned by business-centric capabilities that centre on:
- the ability to devise multiple scenarios that support the investment process
- a deep talent pool well versed with clients' goals
- deep research on thematic investing
- membership of reputable international advocacy groups.

b. Core managerial attributes

The ones that have come under the spotlight lately are:
- the alignment between clients' ESG goals and managers' business governance and culture
- how ESG goals are converted into investment outcomes
- how ESG is embodied into the manager's entire investment value chain.

"Rather than exclude fossil fuel producers from our portfolio, we prefer to engage with them, but are prepared to divest if all else fails."

An interviewee quote

Key message

As a part of the shift from quantity to quality, stewardship, engagement and proxy voting are now the linchpin of ESG investing and as vital as asset allocation, if not more so. Pension plans see themselves as agents of change. As such, they want their asset managers to foster year-round dialogue with portfolio companies that goes beyond shareholder meetings on issues that promote long-term value creation and ESG impacts.

Asset managers are enjoined to raise the bar

Future-proofing pension portfolios became a top priority in 2015 when the UN General Assembly adopted 17 Sustainable Development Goals aimed at creating a more viable global economy and society by 2030. It was soon followed by the Paris COP21 conference. Some 200 nations signed a landmark agreement to galvanise global concerted actions towards a low-carbon future.

When pension plans first embarked on giving mandates to external asset managers for their ESG investments, a key selection criterion was a compelling mission statement. Over time, however, as ESG investing took off in earnest, the selection criteria have expanded in breadth and depth to reflect the complexity of this new form of investing. Some centre on client-centric attributes, others on business-centric attributes. Within these two clusters, some attributes focus on past track record, others on whether a manager's capabilities that have scored highly in the past provide a proxy indicator of future replication.

Taking the first cluster (Figure 5.1, upper panel), the desired track record relates to five areas: stewardship and proxy voting (72%), delivery of clients' ESG goals (67%), a widely admired thought leadership and educational brand (53%), political sensitivity in conveying ESG messaging in a balanced way (51%), and a value-for-money fee structure (51%).

Over time, as ESG investing took off in earnest, the selection criteria have expanded in breadth and depth to reflect the complexity of this new form of investing.

The rank order in this list reflects what our survey respondents see as the primary drivers for success in ESG investing: a detailed plan of engagement with companies in the portfolio, and setting out actions, KPIs and outcome timelines. The plans should also give indications of what asset managers would do if there was insufficient progress on KPIs – such as voting against directors or divesting. In this context, as mentioned in Section 2, the EU's CSRD should assist asset managers in conversations with the companies in which they invest.

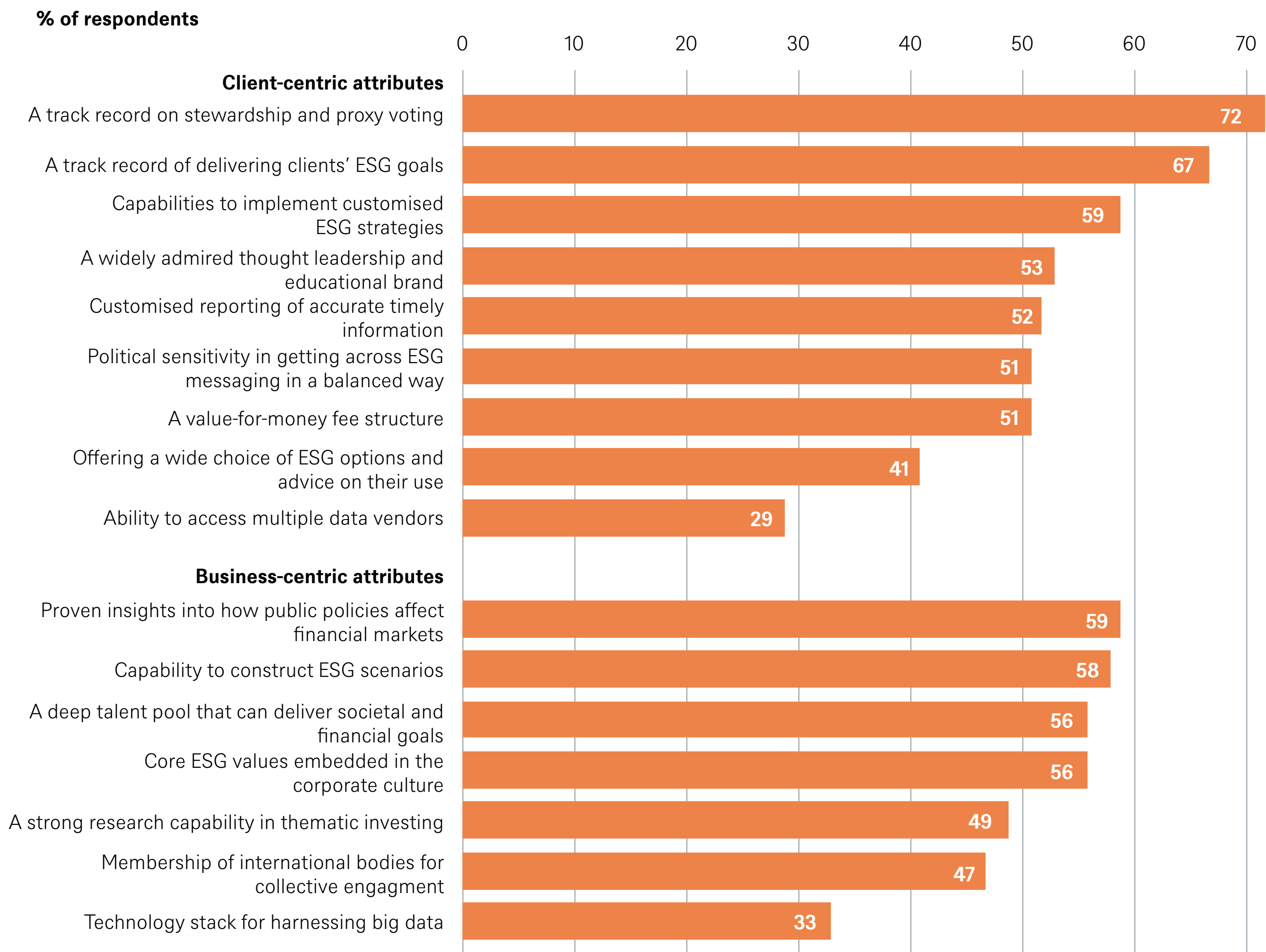
In turn, these client-centric attributes need to be underpinned by various capabilities to ensure that past track record provides a credible guide to future outcomes (Figure 5.1, upper panel). The capabilities in question are: customised ESG strategies (59%), customised reporting of accurate timely information (52%), a variety of ESG options and advice on their use (41%), and access to data vendors of the client's choice (29%).

"We expect our asset managers to match words with deeds and deliver what they say about ESG."

An interviewee quote

Figure 5.1

What attributes of external asset managers do you take into account when deciding to give them your pension plan's ESG mandates?



Source: CREATE-Research Survey 2024

Moving on to business-centric attributes (Figure 5.1, lower panel), here, there are fewer areas of track record than there are areas of capabilities. Taking them in turn, areas of track record centre on proven insights into how public policies affect financial markets (59%), and whether core ESG values are embedded in asset managers' corporate culture such that ESG is not seen as another fad, but, rather, a sea change in the way investing is to be done to achieve the triple bottom line (56%). The reason behind these two items is simple: the new regulatory and policy measures will alter the way the ESG value chain will be reconfigured in future, as the price discovery of ESG risks spreads across the spectrum of capital markets. It should benefit those managers with a keen understanding of both the initial impacts and the subsequent multiplier effects.

The new regulatory and policy measures will alter the way the ESG value chain will be reconfigured in future, as the price discovery of ESG risks spreads across the spectrum of capital markets.

"We need to be sure that track record is based on solid capabilities that ensure that the record is sustained in future."

An interviewee quote

Underpinning these two attributes are various business-centric capabilities (Figure 5.1, lower panel). These include: constructing multiple scenarios to support the investment process (58%); a deep talent pool well versed with clients' triple bottom line goals (56%); research capability in thematic investing (49%); membership of international bodies for engaging collectively on ESG issues (47%); and a technology stack that can harness big data (33%).

Thus, the manager selection process is undergoing its biggest makeover in history. Managers are enjoined to do old things better alongside doing new things, and combine the best of the two as part of adaptive learning. Pension plans too are upping their game (see INSIGHTS).

Insights

Regulation and policies alone will not advance the ESG agenda

The new measures are welcome because official guidance and clarity are essential for advancing the ESG agenda. But, in themselves, they are not enough. As investors, we have a big role to play too. Since we partly own the companies that we invest in, we are closer to the seat of the action than governments are. What we say and do makes a difference.

That's why we have dumped oil and gas majors from our portfolio, after what seemed like long fruitless engagement with them in this decade.

We pulled the trigger to get the message across that our investments have a higher societal purpose as well as a financial goal.

Our next targets are big GHG emitters like steel, cement and car companies. Among them, we have picked those climate laggards that are amenable to working with us in creating business models that are environmentally and socially friendly, while being financially viable during the energy transition phase. At the other end of the spectrum, we are also engaging actively with large banks in our portfolio. They are at the fulcrum of financing projects that will drive the transition away from fossil fuels.

In this context, we welcome the 2023 revisions to the EU Taxonomy, which direct investments to the economic activities most needed for the transition, to include more sustainability-based activities: such as the protection of water and marine resources, the restoration of biodiversity, and the transition to a circular economy that reuses and regenerates materials or products in ways that minimise waste.

Our commitment to ESG remains rock solid, despite the backlash in America and Europe.

An Italian pension plan

"Investors should be able to drill down and know the ingredients underpinning their ESG funds and know the thinking behind them."

An interviewee quote

"With political backlash in the US, the pendulum could conceivably swing back as each climate event becomes more catastrophic."

An interviewee quote

Certain asset manager capabilities require an upgrade

Doubtless, some backsliding on ESG issues by asset managers – especially the large US-based ones – is evident due to the political backlash in their country of domicile. This follows the playbook of great collective ventures in human history where the initial advance is followed by legislation to safeguard public interest that then invites a backlash, which then leads to a slowdown to allow refinements. The implied course mimics the 'punctuated-equilibrium' model – describing an evolutionary process with very short, rapid periods of change followed by long periods of stability, and progress is both slow and intermittent.

Pension plans have become more demanding of their ESG asset managers, as the new regulatory and policy measures begin to bite.

As we saw in Theme 3 in Section 1, the latest challenges to ESG investing have escalated the burden of proof that it actually works. Thus, pension plans have become more demanding of their ESG asset managers, as the new regulatory and policy measures begin to bite. This is especially so, as some large asset managers are softening their activist stance (see INSIGHTS on the next page).

First, asset managers are enjoined to develop and articulate their ESG narrative around the new measures to align it with their clients' goals. The second is to ensure that all senior executives in the business champion ESG values by setting a tone and example that cascade into the company's culture and operations.

The third is to differentiate their products and performance so as to deliver value for money in their fee structure.

The fourth is to achieve organisational efficiencies that can contain the cost pressures made by the new measures.

The fifth is to sharpen their market differentiation by ensuring that their own ESG policies, operations and performance match what they require of their portfolio companies.

The sixth is to enhance the integrity of their products by developing data and reporting systems that minimise the risk of product mislabelling.

Towards these imperatives, pension plans are now looking out for a variety of attributes under three clusters that now underpin the manager selection criteria outlined in the previous subsection.

The first cluster centres on governance and cultural attributes (Figure 5.2, top panel). It specifies a framework in which ESG goals are set, targets are specified, roles are defined, resources are allocated and accountabilities are decided. Central to the framework are two imperatives: the adoption of the net zero goal (70%) and the criticality of stewardship that delivers narratives on real-life stories and examples, their progress and their outcomes (66%).

"That stewardship activities undertaken by at least some asset managers is cosmetic is not in doubt."

An interviewee quote

> "Lately, the political backlash is forcing large asset managers to be wary about supporting activist shareholder proposals on ESG."

An interviewee quote

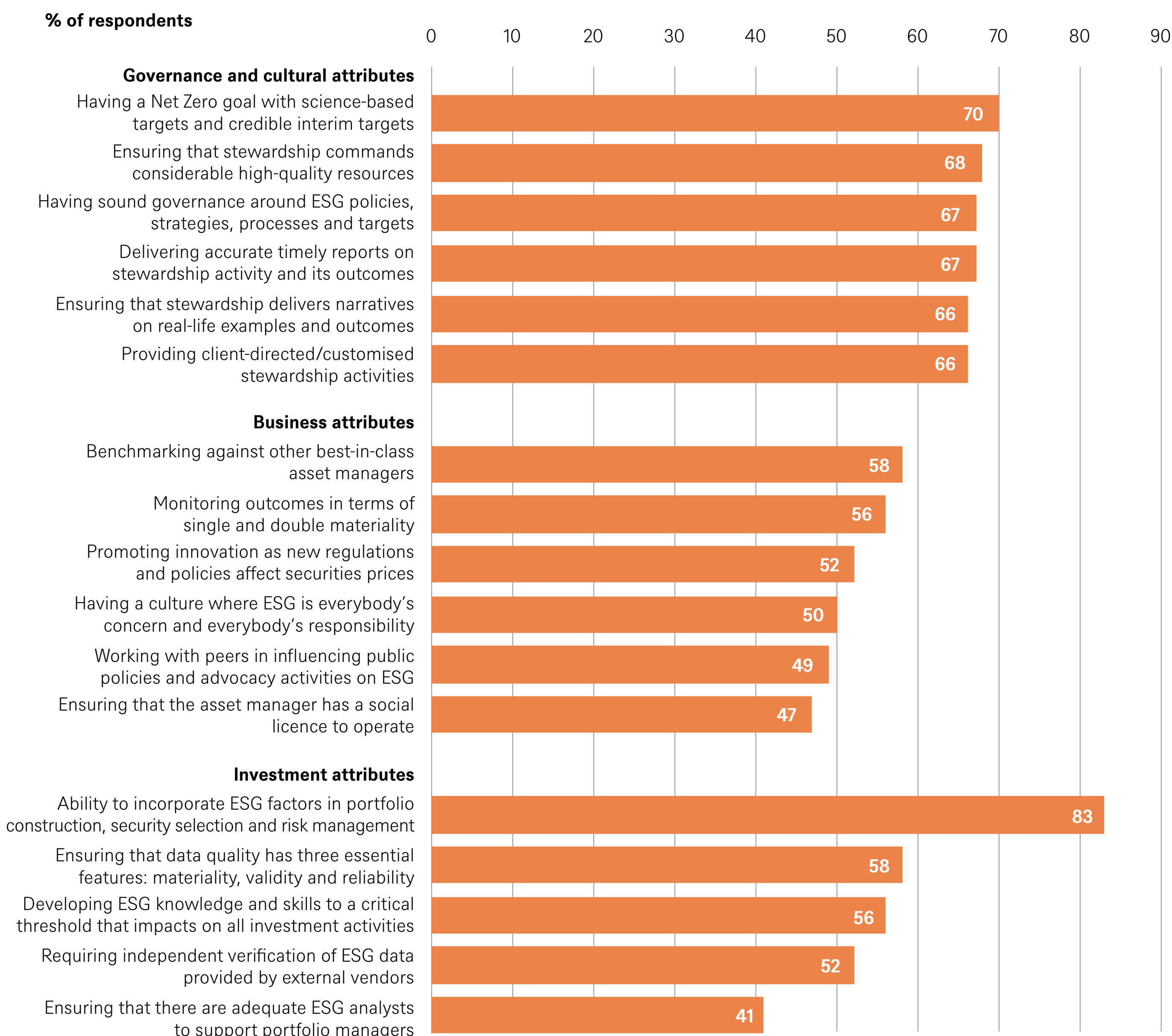
The second cluster centres on business attributes (Figure 5.2, middle panel). These are about critical actions that could convert ESG goals into outcomes. Apart from benchmarking against other best-in-class asset managers (58%), this cluster also involves monitoring investment outcomes in terms of single or double materiality (56%).

The aim is to assess not only how ESG factors are affecting the portfolio's financial outcomes, but also how these, in turn, are benefiting the environment and society.

The third cluster centres on investment attributes (Figure 5.2, bottom panel). These aim to ensure

Figure 5.2

Which of your asset managers' capabilities have become especially important for your pension plan as it assesses the impact of recent regulatory and policy measures on its investment portfolio?



Source: CREATE-Research Survey 2024

"The magnetism of the past remains powerful in stewardship: the old ways of doing things are being reformed in fits and starts."

An interviewee quote

that ESG factors can be effectively integrated into asset allocation, portfolio construction, security selection and risk management (83%) as required by the client, duly taking the new measures into account. It also includes having ESG knowledge and skills to a critical threshold that impacts on all investment activities (56%).

Overall, the items in Figure 5.2 are indicative, not definitive. But the list is long enough to show what the shift from quantity to quality in ESG investing actually implies in practice.

The list is long enough to show what the shift from quantity to quality in ESG investing actually implies in practice.

Insights

Some backsliding on stewardship is evident

Lately, anti-ESG shareholder proposals at AGMs have been on the rise. They aim to roll the clock back to a mid-20th century world, where businesses operated with little regard for their environmental and social impacts. This trend has come just when a clutch of large asset managers have been wary of supporting activist proposals on ESG issues. These managers backed just 7% of such proposals in the 2023 proxy season, down from 47% in 2022. The reason cited was that the rest were too prescriptive or pointless. Some have let their clients decide how their shares are voted.

Others have withdrawn from Climate Action 100+, and are making significant investment in their own stewardship teams. Where they once pressured companies to embrace the ESG agenda, these large managers are now backtracking. Or so it seems.

On the corporate side, earlier this year, ExxonMobil filed a lawsuit against two small activist investors, duly invoking charges of intimidation and bullying. Shell, in turn, is appealing against a 2021 landmark court order to cut its GHG emissions. Clearly, ESG investing is facing an uphill task.

Just as worrying are the results of the UK Asset Owner Roundtable's Stewardship Review in 2023. It revealed that some UK asset managers saw ESG engagement and proxy voting as mutually exclusive. They feared the loss of access to senior management in their portfolio companies by seeming too activist. There was a gap between how they interpreted shareholders' and society's interests. Lately, this has been evident in Canada too. Recent regulation from the EU and UK authorities will support effective stewardship. But, as asset owners, we have to remain vigilant and keep up the pressure.

A UK pension plan

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